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TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1940

No. 8

CRANE-JOHNSON COMPANY, A CORPORATION OF NORTH DAKOTA, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

PETITION FOR CERTIORARI FILED DECEMBER 12, 1939.

CERTIORARI GRANTED MARCH 25, 1940.

United States Circuit Court of Appeals
EIGHTH CIRCUIT.

No. 11,446

TAX REVIEW.

CRANE-JOHNSON COMPANY, PETITIONER,
vs.
COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

ON PETITION TO REVIEW DECISION OF UNITED STATES BOARD OF TAX APPEALS.

FILED MARCH 1, 1939.

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Pleas and proceedings in the United States Circuit Court of Appeals for the Eighth Circuit, at the May Term, 1939, of said Court, before the Honorable Archibald K. Gardner, the Honorable John B. Sanborn and the Honorable Joseph W. Woodrough, Circuit Judges.

Attest:

E. E. KOCH,
Clerk of the United States Circuit Court of Appeals for the Eighth Circuit.

(Seal)

Be it Remembered that heretofore, to-wit: on the first day of March, A. D. 1939, a record on petition to review the decision of the United States Board of Tax Appeals was filed in the office of the Clerk of the United States Circuit Court of Appeals for the Eighth Circuit, in a certain matter wherein the Crane-Johnson Company was Petitioner and the Commissioner of Internal Revenue was Respondent, which said record as prepared and printed under the rules of the United States Circuit Court of Appeals for the Eighth Circuit, under the supervision of its Clerk, is in the words and figures following, to-wit:

[fol. 1] Docket Entries.

Crane Johnson Company, Petitioner,
Docket No. 91809 vs.
Commissioner of Internal Revenue, Respondent.

Appearances:

For Taxpayer: John A. Cull, C. P. A.; John E. Hughes, Esq.

For Comm'r: W. R. Lansford, Esq.

1938

Jan. 3—Petition received and filed. Taxpayer notified. Fee paid. Copy received 1/8/38.

Jan. 3—Copy of petition served on General Counsel.

Mar. 1—Answer filed by General Counsel.

Mar. 1—Request for circuit hearing in St. Paul, Minnesota, filed by General Counsel.

Mar. 11—Notice issued placing proceeding on St. Paul, Minnesota Calendar. Copy of answer and request served.

Apr. 15—Hearing set June 20, 1938, St. Paul, Minnesota.

May 6—Motion for a continuance filed by taxpayer. 5/10/38 Denied.

June 20—Hearing had before Mr. Opper on the merits. Amendment to petition filed. Copy served. Stipulation as to the facts filed. Petitioner's brief due July 20, 1938. Respondent's brief due Aug. 20, 1938. Taxpayer's reply due Sept. 6, 1938.

July 1—Brief filed by taxpayer. 7/2/38 copy served on General Counsel.

Aug. 20—Brief filed by General Counsel.

Sept. 6—Reply brief filed by taxpayer. 9/6/38 copy served on General Counsel.

Dec. 8—Opinion promulgated, Mr. Opper, Division #14. Decision will be entered for the respondent.

Dec. 9—Decision entered, Clarence V. Opper, Div. #14.

1939

Jan. 7—Motion for rehearing and reargument filed by taxpayer.

Jan. 7—Notice of appearance of John E. Hughes as counsel for taxpayer filed.

Jan. 10—Order denying motion for rehearing and reargument, entered.

Jan. 16—Second motion for rehearing filed by taxpayer.

Jan. 23—Order denying second motion for rehearing, entered.

Feb. 6—Petition for review by United States Circuit Court of Appeals, Eighth Circuit, with assignments of error filed by taxpayer.

Feb. 6—Proof of service filed by taxpayer.

Feb. 9—Praecipe for record filed by taxpayer — with proof of service thereon.

[fol. 2] (Petition of Crane-Johnson Company for Appeal.)

(Filed January 3, 1938, U. S. Board of Tax Appeals.)

United States Board of Tax Appeals.

Crane Johnson Company, Petitioner,
Docket Number 91809 vs.
Commissioner of Internal Revenue, Respondent.

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice deficiency IT:D:5-TJB-90D dated November 30, 1937 and as a basis of his proceedings alleges as follows:

1. The petitioner is a North Dakota Corporation with principal office at Fargo, North Dakota.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on November 30, 1937.

3. The taxes in controversy are Undistributed Profits Taxes for the calendar year 1936 and for $1,707.36 exclusive of interest.

4. The determination of tax set forth in the said notice of deficiency is based upon the following error: failure to construe Section 26(c) of the Revenue Act of 1936 as applicable to this corporation, and failure to give effect to the fourteenth amendment to the Constituuion of the United States.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

A. The petitioner is under an impairment of capital as evidenced by balance sheets submitted with the return of income for the year in question (copy of which is attached and marked Exhibit B).

B. The statutes of the State of North Dakota forbid the declaration and/or payment of dividends when and where a deficit obtains — Section 4543, Compiled North Dakota Laws of 1913 as amended reads as follows:

"The directors of a corporation must not make dividends except from the surplus profits arising from the business thereof."

C. This petitioner Corporation is entitled to the credit provided in Section 26(c) Revenue Act of 1936 relating to contracts restricting dividends inasmuch as its charter construed with the state law forbidding dividends when there is a deficit, constitutes such a contract.

Section 26(c) of the 1936 Act provides in part,

"In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

(c) Contracts restricting the payment of dividends.

[fol. 3] (1) Prohibition on payment of dividends — an amount equal to the excess of the adjusted net income over

the aggregate of the amount which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends."

Argument.

Article 26—2 of Regulations 94 provides in part that:

"The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of Section 26(c)."

This provision is not in accord with judicial determinations:—

"The charter of a corporation whether it is created by a special act or formed under a general corporation law, is a contract between the corporation or the incorporators or members and the state", 14 Corpus Juris 162.

Citations.

Dartmouth College vs. Wordward, 3 Wheat 518;

Chicago, etc., Ry. Co. vs. Cutts, 94 N. E. 155;

Miller vs. New York, 15 Wall 478;

Capital City Gas Light Co. vs. Des Moines, 72 Fed. 829.

IT Ruling 3016 Cumulative Bulletin XV 2, page 73 reads,

"A corporation is subject to the surtax imposed by section 14 of the Revenue Act of 1936 on its Undistributed Net Income for 1936, even though the corporation is restricted by State law in declaring and paying dividends while its capital remains impaired."

This ruling is not tenable under the constitution of the United States, Fourteenth Amendment. Taxes must be apportioned by a general rule applied without arbitrary discrimination. To impose a tax on a deficit corporation and excuse from tax one which is in a legal position to pay dividends is discrimination not only arbitrary but discrimination against the weaker corporation and destructive of said weaker corporation.

Wherefore, the petitioner prays that this Board may hear the proceeding and abate the deficiency asserted.

JOHN A. CULL,
Counsel for the Petitioner,
Fargo, North Dakota.

State of North Dakota,
County of Cass—ss.:

A. Hoidston, being duly sworn, says that he is the Secretary of the Crane Johnson Company, a corporation, the petitioner herein, and is duly qualified to verify and that he has read the foregoing petition and is familiar with the statements contained therein, and that the facts stated are true, except as to those facts stated to be upon information and belief and those facts he believes to be true.

A. HOIDSTON.

Subscribed and sworn to before me this 28 day of December, 1937.

L. RYNNING,
Notary Public.

(Notarial Seal)

My Commission Expires Dec. 31, 1941.

[fol. 4] Exhibit A.

IT:D:5
TJB-90D

November 30, 1937.

Crane Johnson Company,
Post Office Box 1540,
Fargo, North Dakota.

Sirs:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1936, discloses a deficiency of $1,707.36, as shown in the statement attached.

In accordance with section 272 (a) of the Revenue Act of 1936, notice is hereby given of the deficiency mentioned. Within ninety days (not counting Sunday or a legal holiday in the District of Columbia as the ninetieth day) from

the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:C1:P-7. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiency and will prevent the accumulation of interest, since the interest period terminates thirty days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING,
Commissioner.
By Chas. T. Russell,
Deputy Commissioner.

Enclosures:
Statement
Form 870
TJB:NB-2

[fol. 5]

Exhibit B

Balance Sheets

Assets	December 31, 1935		December 31, 1936	
Current Assets, etc.				
Cash and Banks	13,428.06		19,523.38	
Notes Receivable	5,141.86		8,490.65	
Accounts Receivable	34,169.64		31,811.98	
Instailment Contract	—		1,100.00	
Merchandise Inventories	74,612.12		90,984.35	
Inventories—Live Stock & Grain	3,828.24		1,332.42	
Expense Inventory—Supplies	487.69	131,667.61	527.96	153,770.74
Investments—Stock				
Stocks	600.00		600.00	
Treasury Stock	4,875.00	5,475.00	4,275.00	4,875.00
Fixed Assets & Property Investments				
Real Estate—Yards		12,464.21		11,383.46
Yard Buildings & Equipment	75,147.00		70,334.32	
Furniture & Equipment—Gen'l Office	4,203.35		4,170.65	
Autos and Trucks	3,384.10		5,228.52	
Farm Lands and Buildings	47,987.22		49,765.86	
Residences, Cafe Bldg. & O. R. E.	13,451.14		7,986.21	
	144,172.81		137,485.56	
Less Depreciation	54,182.59	89,990.22	51,309.44	86,176.12
		239,597.04		256,205.32
Liabilities				
Current Liabilities				
Accounts Payable—Trading	3,144.41		3,996.04	
Accounts Payable—Other	2,150.24		8,602.44	
Interest Accrued Payable	73.55		71.47	
Federal Excise Tax on Employers Payable	—	5,368.20	316.36	12,986.31
Mortgages				
Mortgage Loans		7,105.24		6,961.98
Capital Stock and Surplus				
Capital Stock Issued	250,000.00		250,000.00	
Surplus—Deficit	22,876.40	227,123.60	13,742.97	236,257.03
		239,597.04		256,205.32

[fol. 6] Power of Attorney.

Know All Men By These Presents: That Crane Johnson Company, a corporation organized under the laws of the State of North Dakota, and having its principal office at Fargo, North Dakota, does hereby make, constitute and appoint John A. Cull of Fargo, North Dakota, its true and lawful attorney for it and in its name, to represent it before the Treasury Department of the United States, or any Bureau thereof, or any official or officials of said Department, and also before the United States Board of Tax Appeals, in all matters pertaining to the determination, assessment, collection or payment of any taxes which may be due by it to the United States, or pertaining to claims for refund, abatement or credit based on the assessment or payment of any amounts as such taxes; to inspect any and all of its returns under the Revenue Acts of 1913, 1916, 1917, 1918, 1921, 1924, 1926, 1928, 1932, 1934, the National Recovery Act, and the Revenue Act of 1936, and amendments thereto, respectively; and generally to do, execute and perform every act and thing whatsoever necessary or proper to be done in and about the premises, with full power of substitution.

In Witness Whereof, Said corporation has caused these Presents to be signed in its name, by its Vice President, and attested by its Secretary, and sealed with its corporate seal, this 22nd day of December, A. D. 1937.

CRANE JOHNSON COMPANY,
(Corporate Seal) By W. D. Briggs, Vice-Prest.

Attest:

A. Hoidston.

State of North Dakota,
County of Cass—ss.:

I, L. Rynning, a Notary Public in and for the County and State aforesaid, do hereby certify that W. D. Briggs and A. Hoidston of Crane Johnson Company, and personally known to me to be the same persons whose names are subscribed to the foregoing instrument, appeared before me this day in person and acknowledged that they signed, sealed and delivered said instrument as their free and

voluntary act and deed, and as the free and voluntary act and deed of said corporation, for the uses and purposes therein set forth, and that they were duly authorized to execute the same and to affix the corporate seal thereto.

Given under my hand and notarial seal, this 28 day of December, A. D. 1937.

(Notarial Seal)

L. RYNNING,
Notary Public, Cass County, N. Dak.

My Commission expires Dec. 31, 1941.

[fol. 7] (Answer of Commissioner of Internal Revenue.)

(Filed March 1, 1938, United States Board of Tax Appeals.)

United States Board of Tax Appeals.

Crane Johnson Company, Petitioner,
Docket No. 91809 vs.
Commissioner of Internal Revenue, Respondent.

Comes now the Commissioner of Internal Revenue, respondent above named, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed by the above-named petitioner, admits and denies as follows:

1. Admits the allegations contained in Paragraph 1 of the petition.

2. Admits that the notice of deficiency was mailed to the petitioner on November 30, 1937. Denies the remaining allegations contained in Paragraph 2 of the petition.

3. Admits that the tax in controversy is surtax on undistributed profits for the calendar year 1936 in the amount of $1,707.36.

4. Denies that the Commissioner committed error as alleged in Paragraph 4 of the petition.

5(a), (b), (c). Denies the allegations contained in subparagraphs (a), (b), and (c) of Paragraph 5 of the petition.

[fol. 8] 5(d). Denies the remaining allegations contained in Paragraph 5 of the petition under the caption "Argument."

6. Denies generally and specifically each and every allegation in the petition not hereinbefore admitted, qualified, or denied.

Wherefore, it is prayed that the determination of the respondent be approved and that the petitioner's appeal be denied.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

Of Counsel:

Harry R. Horrow,
Special Attorney,
Bureau of Internal Revenue.

[fol. 9] Amendment to Petition.

(Filed at Hearing on June 20, 1938, U. S. Board of Tax Appeals.)

United States Board of Tax Appeals.

Crane Johnson Company, Petitioner,
Docket No. 91809 vs.
Commissioner of Internal Revenue, Respondent.

Whereas in the fourth and final paragraph of the "argument" in the petition of the within petitioner reference is made in error to the Fourteenth Amendment to the Constitution of the United States, motion is hereby made to make substitution for the word "Fourteenth" so that the paragraph in question will read as follows:

This ruling is not tenable under the Constitution of the United States, Article I, Section 2, Clause 3, also under the Fifth Amendment and the Tenth Amendment.

Taxes must be apportioned by a general rule applied without arbitrary discrimination. To impose a tax on a deficit corporation and excuse from tax one which is in a legal position to pay dividends is discrimination against

the weaker corporation and destructive of said weaker corporation.

JOHN A. CULL,
Counsel for the Petitioner.

[fol. 10] Stipulation of Facts.

(Filed at Hearing on June 20, 1938, U. S. Board of Tax Appeals.)

United States Board of Tax Appeals.

Crane Johnson Company, Petitioner,
Docket No. 91809 vs.
Commissioner of Internal Revenue, Respondent.

It is hereby mutually stipulated and agreed by and between the parties to this appeal through their respective counsel that the Board may take the following facts to be true in the determination of the issue in this appeal, subject to the right of either party to introduce further evidence as is not inconsistent herewith:

1. That the petitioner is a corporation organized under the Statutes of the State of North Dakota and incorporated April 29, 1903.

2. That as of January 1, 1936 the petitioner had a deficit of at least $21,251.40. The deficit shown on the books and on the balance sheet accompanying the return of income was $22,876.40. However, an audit of the books for 1935 made by J. A. Cull and Company, a firm of Certified Public Accountants, disclosed a deficit $1,625.00 less in amount. The difference resulting from the auditors correction of value of Treasury Stock.

3. That the records prior to January 1, 1929 are not susceptible to analysis to definitely show whether this deficit occurred from operating losses or capital distributions in excess of earnings or was effected by other adjustments.

4. That no dividend distributions have been made by the petitioner since March 1930 when $9,672.00 was so distributed from surplus balance [existant] at that time.

5. That the petitioner in its Federal Income Return for the calendar year 1936 claimed a credit under Section

26(c) of the Revenue Act of 1936 against the imposition of surtax on undistributed profits under Section 14(a) which the respondent disallowed and which disallowance is the sole issue in this appeal.

6. That the net income for income tax computation for the year 1936 is $13,450.76.

7. That the respondent computed the petitions liability for surtax as shown below:

Net income for surtax computation		13,450.76
Less Normal Tax		1,418.04
Adjusted Net Income		12,032.72
Undistributed Net Income		12,032.72
Less: Specific credit	5,600.00	
10% of 12,032.72	1,203.27	3,796.73
Remainder subject to surtax		8,235.99

[fol. 11]

Computation of Tax	
7% of 1,203.27	84.23
12% of 1,203.27	144.39
17% of 2,406.54	409.11
22% of 2,406.54	529.44
27% of 1,016.37	274.42
7% of 3,796.73 (Specific Credit)	265.77
Total Surtax	1,707.36
Normal Tax	1,418.04
Total Normal Tax and Surtax	3,125.40
Tax assessed, original, Acc't No. 40388	1,418.04
Deficiency	1,707.36

JOHN A. CULL,
Counsel for Petitioner.

J. P. WENCHEL,
Chief Counsel, Bureau
of Internal Revenue.

[fol. 12] (Opinion of United States Board of Tax Appeals.)

United States Board of Tax Appeals.

Crane Johnson Company, Petitioner,
Docket No. 91809. vs.
Commissioner of Internal Revenue, Respondent.

Promulgated December 8, 1938.

1. A corporation prohibited by state law from declaring dividends because of an existing deficit held not entitled to deduction in computation of the undistributed profits surtax under the Revenue Act of 1936.

2. Undistributed profits surtax held constitutional.

John A. Culi, C. P. A., for the petitioner.

W. R. Lansford, Esq., for the respondent.

Opinion.

Opper: This proceeding involves a deficiency in income tax of $1,707.36 for the year 1936. Petitioner is a corporation incorporated in 1903 under the laws of the State of North Dakota. Among other facts, all of which are found, it is stipulated that "as of January 1, 1936 the petitioner had a deficit of at least $21,251.40" and that "the records prior to January 1, 1929 are not susceptible to analysis to definitely show whether this deficit occurred from operating losses or capital distributions in excess of earnings or was affected by other adjustments." Its "net income for income tax computation for the year 1936 is $13,450.76." No distributions to stockholders were made during the taxable year. Petitioner claims to be entitled to a credit in the amount of its entire current income against the surtax on undistributed profits imposed by section 14 of the Revenue Act of 1936, which would free it from that surtax. The credit provision claimed to apply is section 26 (c) (1), respecting contracts restricting the payment of dividends. It allows credit for:

An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the

corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. * * *

Petitioner argues that nothing could be distributed by it because of section 4543 N. D. Compiled Laws of 1913, which prohibits the payment of dividends by corporations except out of surplus. It claims that its charter constitutes in law a contract with the State (Dartmouth College [fol. 13] case, 4 Wheat. 518) which contract includes all statutes of the state applicable to corporations.

Whether or not under other circumstances the corporate charter and statutes of the state could be said to be a written contract "executed by the corporation," any ambiguity in the provision now under consideration is dispelled by reference to its legislative history. As it passed the House of Representatives the Revenue Bill of 1936 contained three distinct relief provisions imposing in lieu of the graduated undistributed profits tax flat rates of tax irrespective of whether dividends were paid. As explained in detail in the Ways and Means Subcommittee and Committee Reports[1] the provisions were designed respectively for the relief of corporations having deficits (section 14), corporations having outstanding contracts not to pay dividends (section 15), and corporations having outstanding indebtedness (section 16). The provision for corporations having deficits[2] would clearly have applied to the petitioner.[3]

---

[1] House Report No. 2475, 74th Cong., 2d sess., p. 8; Subcommittee Report, p. 6.

[2] Sec. 14. Accumulated Earnings And Profits Less Than Adjusted Net Income.

(a) General Rule.—If the accumulated earnings and profits of the corporation as of the close of the taxable year (computed without diminution by reason of the distribution during the taxable year of earnings and profits, or by reason of the taxes imposed by this title for the taxable year) are less than the adjusted net income, the tax imposed by section 13 shall, in lieu of being computed under section 13, be computed by adding:

(1) A tax of 15 per centum of the excess of the adjusted net income over such accumulated earnings and profits; and

(2) A tax upon the remainder of the adjusted net income (less the tax under paragraph (1) computed under section 13 as if the adjusted net income were equal to the amount of such remainder so reduced.

[3] As stated in the report of the Ways and Means Committee (footnote 1, supra) which proposed a 22½ percent rather than a 15 percent tax:

The Senate changed the undistributed profits tax into a flat rate surtax. It simultaneously struck out sections 14, 15, and 16[4] but retained the principle of relief for corporations under contract not to pay dividends (section 15 of the House Bill) by allowing them a credit against the undistributed profits surtax.[5] Sec. 26 (c) (1). A floor [fol. 14] amendment[6] restored the relief for corporations under contract to pay indebtedness, by inserting a similar credit for them. Sec. 26 (c) (2). But no relief provision was restored for deficit corporations generally. By changing the definition of dividends a "dividends paid" credit was allowed to deficit corporations which distribute current earnings,[7] but no credit was allowed for those which do not distribute.[8]

"It has been recognized that in certain cases corporations cannot pay out dividends or that sound policy demands the nonpayment of dividends. Therefore, in certain cases, a flat rate of tax is imposed on corporate incomes, or parts thereof, in lieu of the undistributed profits tax proposed in the general case.

Deficits.—For example, section 14 of the bill provides that corporations with a deficit shall pay a tax of 22½ percent on the amount of earnings necessary to make up this deficit and only come under the new plan in respect to earnings in excess of this deficit, and in excess of the tax paid at the 22½ percent rate. This rule is more accurately stated in the section.

[4] H. R. 12395, Senate Amendments, Nos. 46 and 48, 74th Cong., 2d sess.; Congressional Record, vol. 80, part 8, pp. 8790, 8791, 74th Cong., 2d sess.

[5] Senate Report No. 2156, 74th Cong., 2d sess., p. 12:

"Instead of having a graduated undistributed-profits tax like the House bill with rates ranging as high as 42.5 percent, your committee has adopted a flat rate of 7 percent. By this moderate rate your committee has eliminated most of the complicated relief provisions in the House bill relating to debt and deficit corporations. However, the principle of the House bill affording relief to corporations which are unable to pay dividends because of express prohibitions in contracts entered into prior to March 3, 1936, have been retained for the purpose of the 7-percent undistributed-profits tax."

[6] Congressional Record, vol. 80, part 8, p. 9071, 74th Cong., 2d sess., and see Conference Report, Revenue Bill of 1936, House Report No. 3068, p. 4.

[7] Sec. 115. Distribution By Corporations.

(a) Definition of Dividend.—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

[8] Although a graduated rate was later substituted for the flat surtax proposed by the Senate (Revenue Act of 1936, sec. 14), the credit provisions remained unchanged.

It does not appear that this omission was unintentional. On the contrary the Finance Committee's explanation[9] of the change in the dividend definition indicates that the reason for the omission may have been the difficulty of determining the existence of accumulated earnings and profits; that is, whether or not there is a true deficit. Precisely that difficulty is illustrated by the present case. Although it is stipulated that a deficit exists, the facts also show that the stipulated deficit reflects only the present book condition and that it can not be shown whether this represents an actual deficit or merely book adjustments prior to 1929, which may or may not have been artificial or improper. The underlying plan of this surtax is to allow credit only for actual distributions. The petitioner, having failed to bring itself clearly within any of the exceptions to that plan, must be governed by the general principle. New Colonial Ice Co. vs. Helvering, 292 U. S. 435.

Petitioner contends further that at least if construed to apply to the present circumstances the undistributed profits surtax is beyond the constitutional power of Congress. We are thus unavoidably required to give a limited consideration to its validity. Rita O'Shaughnessy, Executrix, 21 B. T. A. 1046.

Constitutionality of the measure is attacked on three grounds. First, petitioner claims that it is not a tax on [fol. 15] incomes within the Sixteenth Amendment and therefore is unconstitutional because not apportioned among the states according to population as required by Article I, section 2, of the Constitution. What was said by the Supreme Court in Helvering vs. National Grocery Co., 304 U. S. 282, we believe to be equally applicable here and to be conclusive of the question:

---

[9] Sec. 115 (a). Dividends Out Of Current Earnings.

In order to enable corporations without regard to deficits existing at the beginning of the taxable year to obtain the benefit of the dividends paid credit for the purposes of the undistributed profits surtax, section 115 (a) changes the definition of a dividend so as to include distributions out of the earnings or profits of the current taxable year. The amendment simplifies the determination by providing that distributions during the year, not exceeding in amount the current earnings, are dividends, constituting taxable income to the shareholder and a dividends paid credit to the corporation. As respects such dividends the complicated determination of accumulated earnings or profits is rendered unnecessary. [Emphasis added.] Senate Report No. 2156, 74th Cong., 2d sess., p. 18.

It is said that the statute is unconstitutional because the liability imposed is not a tax upon income, but a penalty designed to force corporations to distribute earnings in order to create a basis for taxation against the stockholders. If the business had been carried on by Kohl individually all the year's profits would have been taxable to him. If, having a partner, the business had been carried on as a partnership, all the year's profits would have been taxable to the partners individually, although these had been retained by the partnership undistributed. See Heiner vs. Mellon, Nos. 144 and 145, decided May 16, 1938. Kohl, the sole owner of the business, could not by conducting it as a corporaton, prevent Congress, if it chose to do so, from laying on him, individually the tax on the year's profits. If it preferred, Congress could lay the tax upon the corporation, as was done by section 104.

Second, petitioner claims that this surtax violates the Tenth Amendment in that "it attempts to regulate the internal affairs of the state in its relation to its corporations by imposing a surtax for failure to distribute", thus disturbing "the whole economic policy of the corporation", "by attempting to state what are dividends and what would be a return of capital contrary to the laws of the state of incorporation", and by offering an inducement for the declaration of dividends in violation of state law which would subject the directors and the corporation to penalties. A similar argument was also advanced and rejected in Helvering vs. National Grocery Co., supra. The statute before us is not invalid "because it interferes with the power to declare or to withhold dividends—a power which the State conferred upon the corporation. The statute in no way limits the powers of the corporation", as Mr. Justice Brandies said in that case. Any corporation not distributing its profits prevents the imposition of the individual surtax thereon. An obstruction to the Federal taxation is thus created. " 'Congress in raising revenue has incidental power to defeat obstructions to that incidence of taxes which it chooses to impose.' United Business Corporation vs. Commissioner, 62 F. (2d) 754, 756." Helvering vs. National Grocery Co., supra.

Third, petitioner alleges that our interpretation of section 26 (c) makes this surtax violative of the due process

requirement of the Fifth Amendment. The crux of this contention as stated in petitioner's reply brief is that:

It discriminates unfairly between corporations of the same class by allowing a dividend paid credit under Section 26 (c) to corporations having written contracts of a particular type, but not allowing a similar credit to other corporations with the same legal obligations differently evi- [fol. 16] denced. It discriminates unfairly against the weaker corporation not permitted under state law to pay dividends and in favor of the stronger corporation in a position to legally pay dividends and thus escape tax liability.[10]

Congress undeniably has the power to levy a tax, graduated or otherwise, on the current income of all corporations, including those having deficits. Foley Securities Corporation, 38 B. T. A. 1036; Long Beach Improvement Co., 5 B. T. A. 590; see Willcuts vs. Milton Dairy Co., 275 U. S. 215, 219; Brushaber vs. Union Pacific Railroad Co., 240 U. S. 1. Petitioner has not been singled out for special taxation. It comes within the general ambit of the tax. Rather it is in reality complaining of the failure to include it in specific exceptions granted to corporations situated in some respects like itself but in other respects differently. Thus it is doubtful whether the petitioner is in a position to raise the constitutional question since the burden of a tax deduction allowed to others falls in too re-

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[10] These arguments as set out more fully in petitioner's main brief are:

"a—It is unreasonable, arbitrary and capricious, at least as to deficit corporations in that it encourages and rewards violation of state law, exacts a penalty for restoring impaired capital, does not conform to established income tax principle of taxing according to ability to pay, exacts a penalty for adherence to soundly established and regularly accepted accounting principles and is an excessive super tax approaching confiscation.

b—It discriminates unfairly between corporations in the same class, by favoring the strong over the weak, by specifically relieving insolvent corporations and other corporations of certain types and failing to relieve the weak but struggling corporations, by allowing a dividend paid credit to corporations which give up and liquidate within the year but providing none for deficit corporations attempting to carry on, by allowing credits under Section 26 (c) to corporations having written contracts of a particular type but not allowing similar credits to other corporations with the same legal obligations differently evidenced, by allowing greater credits under Section 26 (c) to corporations having one large contract than to corporations with the same total obligation made up of several smaller contracts and by failing to provide any dividend credit to corporations suffering a capital loss during the year without having prior earnings at the beginning of the year.

mote and indefinite a way upon the remaining taxpayers. See Frothingham vs. Mellon, 262 U. S. 447, 486. But, in any event, deductions of this type are a matter of legislative grace within the sound discretion of Congress. New Colonial Ice Co. vs. Helvering, supra; Davis vs. United States, 87 Fed. (2d) 323. Petitioner can not complain if this grace did not extend to cover it.

The due process limitations on the taxing power are that the means be "appropriate to the end", Helvering vs. City Bank Farmers Trust Co., 296 U. S. 85; and that the end be taxation rather than confiscation, Brushaber vs. Union Pacific Railroad Co., supra. See also Stella S. Housman, 38 B. T. A. 1007. The objective of the present statute, like the personal holding corporation provisions involved in Foley Securities Corporation, supra, is to subject the income of the corporations concerned "to surtax either in the hands of the stockholders or in the hands of the corporations themselves."[11] In this case, as in the Foley case, that end is accomplished by means which we can not say [fol. 17] are inappropriate. Since the income is not taxable to the stockholders it is taxed to the corporation.

The fact that in certain instances corporations unable for other reasons to distribute their income are expressly exempted or are allowed deductions having a similar effect, does not make the tax confiscatory as to the petitioner. Congress in those instances sacrificed its general objective to make what it considered desirable exceptions. There are many other conceivable situations where distribution of income is difficult or impossible, for which Congress did not think it necessary to provide. Whenever deductions or exemptions are allowed there are necessarily taxpayers in closely related situations who remain subject to the general rule. "The difficulty of adjusting any system of taxation so as to render it precisely equal in its bearing is proverbial and such nicety is not even required of the states under the equal protection clause, much less of Congress under the more general requirement of the due process of law in taxation." La Belle Iron Works vs. United States, 256 U. S. 377. The question is whether the concept under-

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[11] See Ways and Means Committee Report, House Report No. 2475, 74th Cong., 2d sess., p. 4.

lying the statutory treatment "is one that an enlightened legislator might act upon without affront to justice." Burnet vs. Wells, 289 U. S. 670.

The failure of Congress to except deficit corporations generally from the underlying concept of the undistributed profits surtax may be justified on several grounds. Among these are the ease with which a deficit can be created by mere bookkeeping changes;[12] the administrative difficulties of investigating the actual as distinguished from the apparent condition and value of the corporate assets, and the extent of the liabilities, both subject to constant fluctuations;[13] and, particularly pertinent in this case, the fact that the deficit may not be an operating item, as shown by the stipulation of facts, but may have arisen from the management's own improper action in making distributions out of capital. With these possible bases for its action in mind, we can not conclude that Congress acted unreasonably in withholding from deficit corporations the deductions it allowed to certain others, if indeed our determination of that question is required. Certainly there is no discrimination greater than those complained of in the Brushaber case, supra, and none which may reasonably be said to amount to confiscation.

Reviewed by the Board.

Decision will be entered for the respondent.

Seal
U. S. Board of
Tax Appeals
1924

[fol. 18] (Order of Redetermination, December 9, 1938.)

United States Board of Tax Appeals

Washington

Crane Johnson Company, Petitioner,
Docket No. 91809. vs.
Commissioner of Internal Revenue, Respondent.

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[12] See La Belle Iron Works vs. United States, supra, p. 390.
[13] See footnote 9, supra.

Decision.

Pursuant to the determination of the Board, as set forth in its report promulgated December 8, 1938, it is

Ordered and Decided: That there is a deficiency in income tax for the year 1936 in the amount of $1,707.36.

Enter:

Entered Dec. 9, 1938.

(Seal of U. S. Board of Tax Appeals.)

CLARENCE V. OPPER,
Member.

[fol. 19] (Motion of Crane-Johnson Company for Rehearing and Reargument.)

(Filed January 7, 1939, U. S. Board of Tax Appeals.)

On December 8, 1938, this Honorable Board promulgated its opinion in the above entitled case and on December 9, 1938, it entered an order redetermining the deficiency.

The undersigned enters appearance for the taxpayer and in its behalf moves for a rehearing and reargument of this case on three grounds:

(1) The questions presented to this Honorable Board were two, viz.: (a) a question of statutory construction, and (b) a question of constitutional law. They were questions of law only. Until now the taxpayer has not been represented by an attorney at law and the respondent was represented by an attorney at law throughout this proceed-
[fol. 20] ing. In dealing with the pure questions of law involved in this case the Board did not have the assistance of counsel for the taxpayer (compare Johnson vs. Zerbst, 304 U. S. 458, 463) and certain points which it is believed would have necessitated a decision in favor of the taxpayer were not called to the attention of the Board.

The issue presented in this case is one of great importance and of vital consequence to numerous taxpayers located in all parts of this country. It is believed that the Board will welcome the opportunity to thoroughly consider the points of law pointing to a correct solution of the issue and to have the benefit of exhaustive legal argument

for both sides. Of course such exhaustive legal argument cannot be presented in a short petition for rehearing but if rehearing is granted such argument will be presented, Amicus Curiae briefs will be filed and the Board will be in a much better position to decide the issue. In view of the importance of the issue and its novelty no harm can be done by granting this motion and allowing this reargument. A pure and novel question of law and one of first impression, the decision of which will constitute an important precedent and affect many taxpayers should not be decided without full legal argument.

(2) The second ground for rehearing is that the Board has overlooked applicable principles of law. The decision of the Board is based entirely upon legislative history but it is settled that no resort may be had to legislative history unless a statute is ambiguous. Helvering vs. City Bank Farmers Trust Co., 296 U. S. 85, at page 89. The Board in its opinion does not say that the phrase, "a provision of a written contract executed by the corporation prior to May 1, 1936" is ambiguous. Unless it is no resort may be had to legislative history. It is established [fol. 21] by decisions of the United States Supreme Court and it is now Hornbook law that the charter of a corporation unquestionably constitutes "a written contract executed by the corporation." This being so, this charter is literally within the provisions of the above-quoted law. It binds the corporation not to declare dividends as fully as any other written contract might do.

(3) Even based upon legislative history, the decision of the Board is wrong because it is predicated entirely on the baseless assumption that the mere fact that the Senate strikes a provision out of the House Bill shows Congress did not intend some cases which would be included within the stricken provision to be embraced within any other provision of the law. Such an assumption is wholly untenable for non constat the provision was stricken because the Senate considered it too broad and did not intend to grant relief to all deficit corporations, as the stricken provision provided, but only to those restricted by charter from paying dividends.

(4) The Board will surely agree that taxpayers of the country who have thousands of dollars depending upon a

solution of this issue are entitled to a clear and unequivocal declaration on the question whether the charter constitutes a written contract executed by the corporation and if it does, by what authority ambiguous legislative history may be used to except from the plain words of the law "a provision of a written contract executed by the corporation prior to May 1, 1936."

The Question of Statutory Construction.

The statute to be construed is quoted in the opinion of the Board and reads as follows:

"An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without vio- [fol. 22] lating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. * * * "

The particular words to be construed are "without violating a provision of a written contract executed by corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends."

Nothing is better settled than that no resort may be had to legislative history unless a statute is ambiguous. Helvering vs. City Bank Farmers Trust Co., 296 U. S. 85, at page 89. In that case the Committee Report clearly and expressly supported the contention of the taxpayer. The Supreme Court admitted this but said it could not look at the Committee Report or legislative history because the words of the law were plain. See also voluminous Supreme Court cases collected and quoted in Minnesota Tea Co. vs. Commissioner, 76 Fed. (2d) 797, 799.

Is the Board prepared to say the words "a written contract executed by the corporation prior to May 1, 1936" are ambiguous? It does not say so in its opinion. If these words are ambiguous then about everything is ambiguous. Unless the Board can say that they are ambiguous it has no right to resort to legislative history. Hence the taxpayer is entitled to a decision on the question of whether they are ambiguous or not.

Whether they are or are not ambiguous it is Hornbook law that the charter of a corporation constitutes a written

contract executed by the corporation. 14 Corpus Juris, p. 161, Sec. 162. See citations collected in the Supplement to Volume 3 of Paul & Mertens, pages 350-358, Sec. 32 (a) [fol. 23] 43, where the matter is exhaustively discussed. See also Fletcher's Encyclopedia on Corporations, Vol. 7, Sec. 4291, p. 7572, also Sec. 4290. Also, Corporations, R. C. L., Sec. 71, page 93.

In a trial in the District Court a litigant is entitled to present propositions of law to the District Judge and ask the District Judge to rule on such propositions of law. By all rules of fair play, this taxpayer is entitled to a ruling from this Honorable Board on the question whether the charter of a corporation constitutes "a written contract executed by the corporation." This question is not met but is evaded by the opinion rendered herein although it goes to the heart and crux of the case. If the charter does constitute a written contract the Board should say so. Whether the Board thinks Congress excepted such contracts from the benefit of the law is a question to be determined solely from the words of the law above quoted.

Rules of Construction Overlooked in the Opinion.

On the question of statutory construction, the opinion rendered in the case at bar overlooks two well-recognized rules of statutory construction. They are irreconcilable with the opinion.

The Board in its opinion refers to the provision being construed as "a relief provision." Such it manifestly is. The rule for the construction of a relief provision is that its construction must be liberal. In Standifer Construction Corporation, 4 B. T. A. 525, the Board said, at p. 561:

"Relief legislation should be liberally construed in accordance with the well-accepted rule of statutory construction with respect to such legislation."

[fol. 24] See also Johnston, 33 B. T. A. 551, 553; Bonwit, Teller & Co. vs. U. S., 283 U. S. 258, 263.

Furthermore, the Board has also overlooked the applicable rule of statutory construction that doubts, if any, must be resolved in favor of a taxpayer. Hassett vs. Welch, 303 U. S. 303, 314.

Even the Legislative History Does Not Support the Conclusion Reached.

The opinion jumps to the conclusion that because the Senate struck out a provision of the House Bill which would give relief to all deficit corporations it did not intend to give relief to only such deficit corporations as were prohibited from declaring dividends by state law. This does not follow. Non constat the Senate struck out the provision because it considered it too broad as to others and superfluous as to corporations forbidden by law to declare dividends. Surely Members of the Senate must be taken to have been familiar with the Hornbook law that the charter of a corporation constituted a written contract, 7 R. C. L., Sec. 71, page 93. Repetition is inconsistent with a well drawn law.

The Conference Committee once struck a provision out of a Senate Bill which provided that if a taxpayer had filed a claim for credit, a payment made after the Statute of Limitations should not constitute an overpayment. For the history of this provision and for the view that because the Conference Committee struck it out it did not intend it to become law, see the dissenting opinion of Judge Littleton in Naumkeag Steam Cotton Co. vs. U. S., 2 F. Supp. 126, 140 at p. 152.

[fol. 25] The majority of the Court of Claims held otherwise in that case and so did the Supreme Court in Stearns Co. vs. U. S., 291 U. S. 54.

The opinion indulges in speculation that the provision was stricken out because of the difficulty of determining a deficit. This is pure speculation because the reason the provision was stricken does not appear. It is also speculation irreconcilable with the rule that doubts must be resolved in favor of a taxpayer to which more than mere lip service must be given. The difficulty of determining whether a deficit exists is no more difficult than any other valuation question, such as the value of corporate stock, the value of corporate assets for depreciation purposes or for invested capital purposes. If a corporation contracted with X that it would not declare a dividend if a deficit existed the Board would have to decide whether a deficit did exist.

The provision stricken out of the law was so broad that it would give relief to all corporations with deficits regardless of whether the law of the state in which they were incorporated prohibited them paying dividends. There was no reason why corporations which could legally declare dividends should be granted relief if they did not do so. This alone justified the striking of the provision out of the House Bill which granted relief to all corporations with deficits. There was every reason why corporations forbidden to declare dividends should be relieved and we contend they were relieved by an express provision contained in the law and the construction of which is in issue in this case. No reason appears why a distinction should be made between charter contracts and other contracts.

[fol. 26] The legislative history of the law supports the conclusion that Congress intended to give corporations an option to distribute their earnings and not be subject to the tax or not to distribute and become subject to the tax. The provision in the law about contract prohibitions shows this. This taxpayer had no option because its contract with the State forbade the distribution of dividends.

Decision Contrary to Consensus of Impartial Opinion.

The decision in the case at bar is contrary to the views of independent and learned writers on the subject. See Paul & Mertens Supplement to Vol. 3, at pages 350-358, which contains numerous citations of law review articles and other pertinent authorities. See also Montgomery on Income Tax Procedure for 1937, pages 726, 727. See also C. C. H. 1936, paragraph 5279.

Conclusion.

In conclusion it is respectfully submitted that this taxpayer is entitled to a declaration of law from this Honorable Board and express ruling on the following points:

(1) Whether charter of a corporation is "a written contract executed by the corporation." If so, why can it be excepted from the plain words of the law? The opinion rendered herein seems to be based on assuming, without conceding, the charter does constitute "a written contract executed by the corporation," but uses ambiguous legislative history to read an exception into the statute.

[fol. 27] (2) Whether the words of the statute "a written contract executed by the corporation" are ambiguous.

(3) If they are ambiguous whether merely because the Senate strikes a much broader provision out of a House Bill and the legislative history fails to disclose the reason it was stricken it conclusively follows that Congress did not intend any case included within the stricken provision to become law although the law as enacted contains another and narrower provision which includes some but not all cases embraced by the stricken provision.

(4) Whether relief legislation is to be construed liberally and whether all doubts in its construction including doubts in its legislative history are to be resolved in the taxpayer's favor.

In the opinion rendered the Board does not clearly and unequivocally declare itself on any of these points except point (3). They are all vital to a decision of the issue here and taxpayers from which it is sought to take hundreds of thousands of dollars are by the standards of fairness inherent in Judicial decision entitled to a declaration on each of them before their money may be taken.

All of which is respectfully submitted.

JOHN E. HUGHES,
Counsel for Petitioner.

[fol. 28] Appendix.

"The directors of a corporation must not make dividends except from the surplus profits arising from the business thereof." Sec. 4543 North Dakota Compiled Laws of 1913.

In 14 Corpus Juris, p. 161, Sec. 162, the rule of law applicable here is thus stated:

"The charter of a corporation, whether it is created by a special act or formed under a general corporation law, is a contract between the corporation, or the corporators or members, and the state. It is a contract beween the state and the corporation, between the corporation and the stockholders, and between the stockholders and the state."

In Vol. I, Fletcher Cyclopedia Corporations at p. 440, Sec. 226, the law is thus stated:

"In other words, the provisions of the statute or general incorporation act enter into and form a part of the charter, and the incorporation papers and statute are to be construed together, the latter controlling in case of a conflict.

"It is not necessary that the general law should be copied in the charter, but it forms an essential part of it, and all parties are bound by its terms, whether copied in the charter or found only on the statute book."

See also Vol. 2, Chap. 20, Sec. 765, p. 1736.

[fol. 29] We concede that Congress did not intend to grant relief to deficit corporations generally (deficit corporations in a State where the law allowed the payment of dividends), but that has nothing to do with the question at issue here. It was necessary to change the definition of dividends to enable corporations in a State the law of which did not prevent a distribution of earnings, to come clearly within this credit. The statement in the Committee Report about the complicated determination of "accumulated earnings" had in mind the experience of the profits tax laws involving the tentative tax computation. See Article 857, Reg. 62. Ayers & Co., 1 B. T. A. 1135. It did not have in mind corporations with deficits existing long prior to the taxable year.

Motion for a Declaration of Law.

Comes now the taxpayer by its counsel and moves that this Honorable Board specifically declare or refuse to declare each of the following propositions of law, material to a decision of this case by marking the same "held" or "refused".

(1) The charter of the corporation is a written contract between the corporation and the state. (Corporations, 7 Ruling Case Law, Sec. 71, page 93; 14 C. J., Sec. 162; Cook on Corporations, 8th Edition, Secs. 492-494.)

(2) The provisions of the general corporation law of North Dakota are a part of said charter.

(3) Section 4543 N. D. Compiled Laws of 1913 prohibits the payment of dividends by corporations except out of surplus. No dividend could be declared without vio-
[fol. 30] lating this provision of the contract between the corporation and the state.

(4) The following words of Section 26 (c) (1) of the Revenue Act of 1926, "without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which expressly deals with the payment of dividends,"—are not ambiguous.

(5) Unless words of a statute are ambiguous no resort may be had in its construction to legislative history.

(6) All doubts in the construction of a statute are to be resolved in a taxpayer's favor and relief legislation is to be liberally construed in favor of taxpayers.

(7) Even in cases where resort may be had to legislative history, in a case where a statute as originally presented contains two provisions one of which is much broader and embraces more classes than the other and the Legislature strikes out the broader provision but allows the other provision to remain in the law, the cases falling within the remaining provision cannot be read out of it because the broader provision was stricken by the Legislature.

JOHN E. HUGHES,
Attorney for Taxpayer.

[fol. 31] (Order denying Motion for Rehearing.)

United States Board of Tax Appeals.

Crane Johnson Company, Petitioner,
Docket No. 91809. vs.
Commissioner of Internal Revenue, Respondent.

The opinion herein having been promulgated December 8, 1938, and decision thereon having been entered December 9, 1938, and petitioner having on January 7, 1939, by its counsel, John E. Hughes, Esq., filed a "Motion For Rehearing And Reargument" herein, upon due consideration thereof it is

Ordered: That the said motion be and the same hereby is denied.

CLARENCE V. OPPER,
Member.

Dated: January 10, 1939.
Washington, D. C.

Seal
U. S. Board of
Tax Appeals
1924

[fol. 32] (Second Motion of Crane-Johnson Company for Rehearing.)

(Filed January 16, 1939, United States Board of Tax Appeals.)

Comes now the petitioner by its counsel and moves for a rehearing on the ground that the denial of its first motion for rehearing is a denial of the requirements of due process of law.

In this case there were no facts in dispute. They were stipulated. The only question involved was a question of law. The respondent was represented by able and experienced counsel. The petitioner was not represented by an attorney at law. After the entry of the decision herein the petitioner, by an attorney at law, moved for a rehearing and reargument and one of the grounds of the motion was that it had not been heretofore heard on this question of law, through an attorney at law.

Petitioner relies upon the following decisions of the Supreme Court of the United States:

[fol. 33] In Railroad Commission vs. Pacific Gas & Electric Co., 302 U. S. 388, the court said at page 393:

"The right to a fair and open hearing is one of the rudiments of fair play assured to every litigant by the Federal Constitution as a minimal requirement. Ohio Bell Tel. Co. vs. Public Utilities Commission, 301 U. S. 292, 304."

The Sixth Amendment to the Constitution provides that a defendant may not be deprived of liberty unless he is

represented by counsel. We think it is implicit in Johnson vs. Zerbst, 304 U. S. 458, that this requirement of fair play would have been embraced within the Fifth Amendment in any event and that one may not be deprived of property as well as liberty without being heard by an attorney at law. In Johnson vs. Zerbst, 304 U. S. 458, the court said at page 462 and page 463 that the Sixth Amendment,

"embodies a realistic recognition of the obvious truth that the average defendant does not have the professional skill to protect himself when brought before a tribunal with power to take his life or liberty, wherein the prosecution is presented by experienced and learned counsel: That which is simple, orderly and necessary to the lawyer—to the untrained layman—may appear intricate, complex and mysterious. Consistently with the wise policy of the Sixth Amendment and other parts of our fundamental charter,* this Court has pointed to 'the humane policy of the modern criminal law' which now provides that a defendant 'if he be poor may have counsel furnished him by the state.'"

Again the Supreme Court said:

[fol. 34] "The right to be heard would be, in many cases of little avail if it did not comprehend the right to be heard by counsel. Even the intelligent and educated layman has small and sometimes no skill in the science of law."

In view of the foregoing expressions, the denial of the motion for a rehearing amounted to a denial of the right to be represented by counsel and is a denial of due process of law.

In Ohio Bell Tel. Co. vs. Public Utilities Commission, 301 U. S. 292, the court said at page 304 that the right to a fair hearing "is one of the rudiments of fair play."

Again the court said at page 305:

"There can be no compromise on the footing of convenience or expediency or because of natural desire to be rid of harassing delay, when the minimal requirement has been neglected and ignored."

*Underlining ours for emphasis.

By admitting Certified Public Accountants to practice before it the Board has represented that they are competent to do so and the taxpayer did not waive the right to counsel because it relied upon the Board's representation.

A further ground of this motion for rehearing is "the one who decides must hear." (Morgan vs. United States, 298 U. S. 468, 481) and the other members of the [division] deciding this case did not hear the case. Mr. Opper alone heard it.

All of which is respectfully submitted.

JOHN E. HUGHES,
Attorney for Petitioner.

[fol. 35] (Order denying Second Motion for Rehearing.)

Under date of December 8, 1938, there was promulgated the Board's opinion in the above entitled proceeding and based thereon there was entered on December 9, 1938 the Board's decision. Under date of January 7, 1939, counsel for the petitioner filed a motion for rehearing and reargument, which motion was denied on January 10, 1939. There has now been filed with the Board under date of January 16, 1939, a "Second Motion for Rehearing" by counsel for the petitioner. Careful consideration has been given to petitioner's motion and it is believed that it should be denied. It is therefore

Ordered: That the said motion be and the same hereby is Denied.

C. R. ARUNDELL,
Member.

Dated: January 23, 1939.

Seal
U. S. Board of
Tax Appeals
1924

[fol. 36] (Petition of Crane-Johnson Company for Review of Decision of United States Board of Tax Appeals.)

(Filed February 6, 1939, United States Board of Tax Appeals.)

United States Board of Tax Appeals

Washington

Crane-Johnson Company, Petitioner,
Docket No. 91,809 vs.
Commissioner of Internal Revenue, Respondent.

Comes now the above-named petitioner by its counsel, and hereby petitions that the decision of the Board in the above-entitled case be reviewed by the Circuit Court of Appeals for the Eighth Circuit according to law.

The decision of the Board herein was entered December 9, 1938. Petitioner's second motion for rehearing was denied January 23, 1939.

Nature of Controversy.

(1) This case involves undistributed profits and surtax for the calendar year 1936. It was stipulated that "on January 1, 1936 the petitioner had a deficit of at least $21,251.40." It was stipulated that petitioner's net income for 1936 was $13,450.76. This is less than petitioner's deficit. The question in this case is whether petitioner is entitled to a credit in the amount of the foregoing net in- [fol. 37] come for 1936 against the surtax on undistributed profits imposed by Section 14 of the Revenue Act of 1936. The credit provision is 26 (c) (1) of the Revenue Act of 1936, which reads as follows:

"An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends."

Petitioner was forbidden by Section 4543 North Dakota Compiled Laws of 1913 to declare any dividend for 1936. It contends that the said law enters into and is a part of its Charter and that its Charter is "a written contract

executed by it prior to May 1, 1936, which expressly deals with the payment of dividends." Petitioner was incorporated in 1930 under the Laws of the State of North Dakota.

The question for this court to decide is whether the said Charter constitutes "a written contract executed by the corporation prior to May 1, 1936." If it does, the deficiency of $1707.36 which the Board held petitioner was liable for for the taxable year 1936, is eliminated.

Assignments of Error.

(1) The Board erred in failing to enter an order that petitioner was not liable for the deficiency claimed by respondent.

(2) The Board erred in sustaining the determination of the respondent.

[fol. 38] (3) The Board erred in failing to hold that the statutory law of North Dakota was a part of petitioner's Charter, and that petitioner's Charter constituted a written contract executed by it prior to May 1, 1936, which contract contained a provision expressly dealing with the payment of dividends and that no dividends could be distributed without violating this law and hence petitioner was entitled to the credit allowed in 26 (c) (1) of the Revenue Act of 1936.

(4) The Board erred in failing to hold that Section 26 (c) (1) of the Revenue Act of 1936 was not ambiguous and hence no resort could be had to legislative history.

(5) The Board erred in resorting to legislative history without passing on the question whether such provision was ambiguous.

(6) The Board erred in improperly misconstruing and misapplying the legislative history of the provision in question in failing to hold that the legislative proceedings were not inconsistent with an intention to allow the credit claimed in the case at bar.

(7) The Board erred in failing to consider and apply the rules of statutory construction that all doubts in a taxing statute are to be resolved in favor of a taxpayer

and that a relief provision is to be construed liberally in a taxpayer's favor.

[fol. 39] (8) The Board erred in raising of its own motion an issue not raised by the parties.

(9) The Board erred in denying petitioner's two motions for re-hearing and in depriving it of the right to be heard by counsel.

Wherefore, petitioner prays that the decision of the Board may be reversed.

JOHN E. HUGHES,
First National Bank Bldg.,
Chicago, Illinois,
Attorney for Petitioner.

State of Illinois,
County of Cook—ss.:

John E. Hughes being duly sworn, says that he is the attorney for the petitioner above-named and he has read the foregoing petition for review and that he verily believes the Board erred in point of law as therein stated.

JOHN E. HUGHES.

Subscribed and Sworn to before me this 4th day of February, A. D. 1939.

(Seal)

FRANCES V. SCHULTZ,
Notary Public.

[fol. 40] Praecipe for Transcript of Record.

(Filed February 9, 1939, United States Board of Tax Appeals.)

To the Clerk of the United States Board of Tax Appeals:

Sir:

Please prepare and transmit to the Clerk of the United States Circuit Court of Appeals for the Eighth Circuit, the following in the above-entitled case:

(1) The Docket entries.

(2) All pleadings before the Board.

(3) The Stipulation of the parties.

(4) The opinion and decision of the Board.

(5) The two Motions for rehearing filed by petitioner and orders denying same.

(6) Petition For Review.

JOHN E. HUGHES.

Received a copy of the above and foregoing Praecipe this 9th day of February, A. D. 1939.

J. P. WENCHEL,
Chief Counsel, Bureau
of Internal Revenue.

[fol. 41] (Clerk's Certificate to Transcript.)

United States Board of Tax Appeals

Washington

Crane-Johnson Company, Petitioner,
Docket No. 91809. vs.
Commissioner of Internal Revenue, Respondent.

Certificate.

I, B. D. Gamble, clerk of the U. S. Board of Tax Appeals, do herby certify that the foregoing pages, 1 to 40, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal as above numbered and entitled.

Seal
U. S. Board of
Tax Appeals
1924

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 20th day of February, 1939.

B. D. GAMBLE,
Clerk, United States Board
of Tax Appeals.

Filed Mar. 1, 1939. E. E. Koch, Clerk.

[fol. 38] And thereafter the following proceedings were had in said cause in the Circuit Court of Appeals, viz.:

(Appearance of Counsel for Petitioner.)

United States Circuit Court of Appeals,
Eighth Circuit.

Crane-Johnson Company, Petitioner,
No. 11,446. vs.
Commissioner of Internal Revenue.

The Clerk will enter my appearance as Counsel for the Petitioner.

JOHN E. HUGHES,
38 South Dearborn Street
Chicago, Illinois.

(Endorsed): Filed in U. S. Circuit Court of Appeals, Mar. 3, 1939.

(Appearance of Mr. J. P. Wenchel and Mr. John M. Morawski as Counsel for Respondent.)

The Clerk will enter my appearance as Counsel for the Respondent.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

JOHN M. MORAWSKI,
Special Attorney, Bureau of Internal Revenue.

(Endorsed): Filed in U. S. Circuit Court of Appeals, Mar. 9, 1939.

[fol. 39] (Appearance of Mr. James W. Morris and Mr. Sewall Key as Counsel for Respondent.)

The Clerk will enter my appearance as Counsel for the Respondent.

JAS. W. MORRIS,
Assistant Attorney General.

SEWALL KEY,
Special Assistant to the Attorney General.
Department of Justice,
Washington, D. C.

(Endorsed): Filed in U. S. Circuit Court of Appeals, Mar. 10, 1939.

(Appearance of Miss Helen R. Carloss as Counsel for Respondent.)

The Clerk will enter our appearances as Counsel for the Respondent.

JAMES W. MORRIS,
Assistant Attorney General.

SEWALL KEY,
HELEN R. CARLOSS,
Special Assistants to the
Attorney General.

(Endorsed): Filed in U. S. Circuit Court of Appeals, May 22, 1939.

[fol. 40] (Appearance of Mr. Philip F. Biggins as Amicus Curiae.)

The Clerk will enter my appearance as Counsel for the Amicus Curiae.

PHILIP F. BIGGINS,
315 Evening Star Building,
Washington, D. C.

(Endorsed): Filed in U. S. Circuit Court of Appeals, May 17, 1939.

(Appearance of Mr. Thomas H. Remington and Mr. Albert S. Willey as Counsel for Amicus Curiae.)

The Clerk will enter my appearance as Counsel for the Amicus Curiae.

THOMAS H. REMINGTON,
ALBERT S. WILLEY,
1224 Lincoln Alliance Bank Bldg.,
Rochester, New York.

(Endorsed): Filed in U. S. Circuit Court of Appeals, May 20, 1939.

(Appearance of Mr. Claude W. Dudley and Mr. Davis Biggs, Jr., as Counsel for Amicus Curiae.)

The Clerk will enter my appearance as Counsel for the Amicus Curiae.

CLAUDE W. DUDLEY,
DAVIS BIGGS, JR.,
of Carter & Jones.

(Endorsed): Filed in U. S. Circuit Court of Appeals, May 22, 1939.

[fol. 41] (Order of Submission.)

May Term, 1939.

Monday, May 29, 1939.

This cause having been called for hearing in its regular order, argument was commenced by Mr. John E. Hughes for petitioner, continued by Miss Helen R. Carloss, Special Assistant to the Attorney General, for respondent, and concluded by Mr. John E. Hughes for petitioner.

Thereupon, this cause was submitted to the Court on the transcript of the record from said Board of Tax Appeals, the briefs of counsel for the respective parties and those filed by amici curiae.

[fol. 42] (Opinion.)

United States Circuit Court of Appeals,
Eighth Circuit.

No. 11,446.—MAY TERM, A. D. 1939.

Crane-Johnson Company, Petitioner,
vs.
Commissioner of Internal Revenue, Respondent.

On Petition to Review Decision of United States Board of Tax Appeals.

[August 3, 1939.]

Mr. John E. Hughes for Petitioner.

Miss Helen R. Carloss, Special Assistant to the Attorney General (Mr. Sewall Key, Special Assistant to the Attorney General, was with her on the brief) for Respondent.

Mr. Thomas H. Remington filed a brief as amicus curiae.

Mr. Philip F. Biggins filed a brief as amicus curiae.

Mr. Claude W. Dudley and Messrs. Carter & Jones filed a brief as amicus curiae.

Before GARDNER, SANBORN and WOODROUGH, Circuit Judges.

GARDNER, Circuit Judge, delivered the opinion of the court.

This is a petition to review a decision of the United States Board of Tax Appeals. The facts were stipulated and hence are not in dispute. Petitioner, a corporation, was organized under the laws of the State of North Dakota in 1903. As of January 1, 1936, it had a deficit of $21,251.40. The records, prior to January 1, 1929, do not show whether the deficit occurred from operating losses or capital distributions in excess of earnings, or other adjustments. No dividend distribution had been made by the petitioner since March, 1930, when $9,672.00 was distributed from its surplus balance. In its income tax return for the calendar year 1936, it claimed a credit under Section 26 (c) of the Revenue Act of 1936 against the imposition of surtax on undistributed profits under Section 14 (a), which the commissioner disallowed. The net income computed for 1936 was $13,450.76. The commissioner found a deficiency of $1,707.36 on an undistributed net income which he found to exist in the amount of $12,032.72. The Board of Tax Appeals having sustained this determination, the petitioner seeks a review of that decision.

It is the contention of the petitioner that it was not subject to the undistributed profits surtax because it did not have any surplus or undivided profits from which, under the laws of North Dakota, any dividends could lawfully have been paid or distributed.

Section 4543 of the North Dakota Compiled Laws of 1913 provides that:

"The directors of corporations must not make dividends except from the surplus profits arising from the business thereof; nor must they divide, withdraw, or pay to the stockholders, or any of them, any part of the capital stock, nor must they create debts beyond the subscribed capital stock * * *."

Section 4544 provides as a penalty for a violation of Section 4543 that the directors under whose administration a violation shall have occurred, except those who have caused their dissent therefrom to be entered at large on the minutes or were not present, shall in their individual and private capacity be jointly and severally liable to the corporation and to the creditors thereof, in the event of its dissolution, to the full amount of the capital stock so divided withdrawn, paid out, or reduced, or the debt contracted.

The Revenue Act of 1936 imposed a special surtax on that part of the profits of the corporation not distributed as dividends. Section 26 (c) allowed a credit against the income on which this tax was imposed in the event a corporation was expressly restricted from payment of dividends by "a written contract executed by the corporation prior to May 1, 1936." It is the contention of petitioner that the North Dakota law became a part of the contract between the corporation and the state, and hence, by the provisions of Section 26 (c) (1) of the Revenue Act of 1936, it was entitled to credit for dividends which could not be paid in violation of a written contract executed by the corporation, and that if the Revenue Act should be construed to tax the corporation because its directors refused to violate the state law, the Act violated the Fifth Amendment to the Constitution.

The Supreme Court of North Dakota has held that a dividend can not rightfully be declared by a corporation except out of the profits earned by it, and that this principle is embodied in the North Dakota statutes above referred to. *Ulness* v. *Dunnell* (N. D.) 237 N. W. 208. Similar statutory provisions were in existence when petitioner was incorporated.

The question for determination is whether, within the purview of Section 26 (c) (1) of the Revenue Act of 1936, petitioner's charter, including as it doubtless does the North Dakota statutes, constituted a "written contract executed by the corporation." For some purposes, the charter of a corporation may be said to be a contract with the state, and the laws, constitutional or statutory, of the state where the corporation is organized become a part

of its articles of incorporation, so that the charter of a corporation organized under general law consists of its articles of incorporation and the laws applicable thereto. Here, the articles of incorporation and such certificate as may have issued on the organization of the corporation contain no provision restricting dividend payments. It is necessary, therefore, to look to the statutes of North Dakota for the restriction, and to determine whether the state law of North Dakota is a written contract executed by the corporation.

As has been observed, Section 4543 of the North Dakota Compiled Laws contains a prohibition against improper declaration of dividends by directors, and Section 4544 penalizes such consenting directors by making them jointly and severally liable to the corporation and to the creditors in the event of dissolution, to the full amount of the capital stock reduced. These statutes, we think, do not establish a contract executed by the corporation expressly dealing with the payment of dividends. If there is such a contract, it is not an express one, but is implied. Under these statutes, the directors assume a liability as to creditors akin to that of suretyship, and the corporation may itself hold its directors liable for improper distribution of its assets. The obligation is that of the directors, and in the event of the improper exercise of their power to declare dividends, they, as distinguished from the corporation, may be held liable for the consequences of a violation of the statute. Under the North Dakota statutes the liability is statutory and is purely one between the directors and the creditors. The corporation itself has made no written contract affecting its right to declare dividends.

Section 26 (c) (1) of the Revenue Act of 1936, which is invoked, is a credit provision granting credits or exemptions. Such provisions in the tax laws are to be strictly construed. *Helvering* v. *Inter-Mountain Life Insurance Co.*, 294 U. S. 686; *Heiner* v. *Colonial Trust Co.*, 275 U. S. 232; *United States Trust Co.* v. *Anderson* (CCA2) 65 Fed. (2d) 575.

We are here considering a tax law, and the question is not whether for any purpose a charter or a state law may be treated as a contract, but rather whether they together may be considered a written contract executed by the corporation within the meaning of Section 26 (c) (1) of the Revenue Act of 1936. Such contract as arises from the organization of a corporation under state laws is an implied rather than a voluntary written agreement entered

into by the corporation. Congress has the power to levy a tax on corporate net income even though there be an impairment of capital. *Willcuts* v. *Milton Dairy Co.*, 275 U. S. 215.

It is worthy of note that an analogous provision is found in Section 26 (c) (2) of the Revenue Act of 1936, which allows a credit of an amount equal to the portion of the earnings and profits of the taxable year which is required "by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been paid or set aside." Clearly, this provision relates to a corporate undertaking to discharge a certain obligation out of earnings, and not to any statutory provisions. These similar provisions should be construed by the same rule.

Conceding the petitioner fully bound by the North Dakota statutes inhibiting the declaration of dividends, it does not follow that it is entitled to the exemption or credit which Congress saw fit to grant.

It is further urged that if construed to tax a corporation because it failed to do an unlawful and criminal act, the statute violates the Fifth Amendment. But no North Dakota statute has been called to our attention which makes it a crime to declare a dividend out of capital. Petitioner is urging the court to decide a question of constitutional law based upon a hypothetical set of facts, which is not permissible. *Tennessee Publishing Co.* v. *American Nat. Bank*, 299 U. S. 18; *Cincinnati* v. *Vester*, 281 U. S. 439; *Anniston Mfg. Co.* v. *Davis*, 301 U. S. 337.

In the list of points to be argued in petitioner's brief appears the point that the Board should have granted the petition for rehearing. The matter is not referred to in the body of the brief and should probably be treated as abandoned. It is, however, referred to in certain briefs filed *amicus curiae*. On this point we think it sufficient to say that such a petition is addressed to the discretion of the Board, and in the absence of an abuse of discretion its ruling should not be disturbed. The basis for the petition was the fact that the petitioner was represented before the Board by a certified public accountant who was not a lawyer. It is strenuously urged that such a public accountant was engaged in the unauthorized practice of law. Rule 2 of the Rules of Prac-

tice and Procedure before the Board of Tax Appeals permits certified public accountants duly qualified under the laws of any state or territory or the District of Columbia to practice before the Board. This rule was promulgated under Section 907 (a) of the Revenue Act of 1924 as amended. Title 26 U. S. C. A. Sec. 611.

The statute gave the Board full authority to make rules governing the practice before it. *Goldsmith* v. *Board of Tax Appeals*, 270 U. S. 117. Petitioner voluntarily made its choice of representative. After an adverse decision, petitioner argues that as only a question of law was presented, it was entitled to go before the Board through a lawyer. It was undoubtedly in the first instance entitled to be so represented had it so elected; but it is certainly not in position to complain that the Board did not compel it to be so represented. In the denial of petition for rehearing, we are of the opinion that there was no abuse of discretion. *Bankers Pocahontas Coal Co.* v. *Burnet*, 287 U. S. 308. We are not here attempting to determine the question as to whether the appearance before the Board by a certified public accountant constituted the unlawful practice of law in the District of Columbia. We have no jurisdiction or power to determine that question, and in any event it would be improper to pass judgment upon such a question in the absence of notice to and an opportunity to be heard on the part of the certified public accountant who appeared for the petitioner. *In re Noell* (CCA8) 93 Fed. (2d) 5.

The decision of the Board of Tax Appeals is therefore

Affirmed.

[fol. 48]

(Decree.)

United States Circuit Court of Appeals,
Eighth Circuit.

May Term, 1939.

Tuesday, August 8, 1939.

Crane-Johnson Company, Petitioner,
No. 11,446. vs.
Commissioner of Internal Revenue.

On Petition to Review Decision of United States Board of Tax Appeals.

This cause came on to be heard on the petition to review a decision of the United States Board of Tax Ap-

peals redetermining a deficiency in the income tax of the petitioner for the year 1936, and was argued by counsel.

On Consideration Whereof, It is now here ordered, adjudged and decreed by this Court that the decision of the said Board of Tax Appeals in this cause, be, and the same is hereby, affirmed.

And it is further ordered by this Court that the petition to review herein, be, and the same is hereby, dismissed without the taxation of costs in favor of either of the parties in this Court.

August 8, 1939.

[fol. 49] (Petition For Rehearing and Motion For Leave to Amend Petition for Rehearing.)

Memorandum of Clerk:

And thereafter on September 1, 1939, petition for rehearing was filed by counsel for petitioner, within the provisions of an order of the Court extending time for filing petition for rehearing, and on September 2, 1939, motion of petitioner to amend petition for rehearing was filed, which matters are omitted pursuant to praecipe for transcript filed by counsel for petitioner.

(Order Denying Motion to Amend Petition For Rehearing and Petition for Rehearing.)

May Term, 1939.

Friday, September 15, 1939.

In this cause the petition for rehearing filed by counsel for petitioner and motion to amend said petition have been considered, and It is now here Ordered by this Court that the motion to amend and the petition for rehearing be, and they are each hereby, denied.

September 15, 1939.

[fol. 50] (Praecipe For Transcript For Supreme Court, U. S.)

Sir:

In preparing the record of proceedings in the Circuit Court of Appeals on Writ of Certiorari, please omit the Petition for Rehearing and the Motion to amend said Petition for Rehearing. Show that a Petition for Rehearing was filed and the date thereof and also the date it was denied and the order denying the same. Also omit all captions.

Except for the above omissions the record should be the usual record prepared by you for a Petition for the Writ of Certiorari.

JOHN E. HUGHES,
Attorney for Petitioner.

(Endorsed): Filed in U. S. Circuit Court of Appeals, Oct. 26, 1939.

[fol. 51] (Clerk's Certificate.)

United States Circuit Court of Appeals,
Eighth Circuit.

I, E. E. Koch, Clerk of the United States Circuit Court of Appeals for the Eighth Circuit, do hereby certify that the foregoing contains the record on petition to review the decision of the United States Board of Tax Appeals as prepared and printed under the rules of the United States Circuit Court of Appeals for the Eighth Circuit, under the supervision of its Clerk, and full, true and complete copies of the pleadings, record entries and proceedings, including the opinion, had and filed in the United States Circuit Court of Appeals, except the full captions, titles and endorsements omitted in pursuance of the rules of the Supreme Court of the United States, prepared in accordance with the praecipe of counsel for petitioner, in a certain cause in said Circuit Court of Appeals wherein Crane-Johnson Company was Petitioner and the Commissioner of Internal Revenue was Respondent, No. 11,446, as full, true and complete as the originals of the same remain on file and of record in my office.

I do further certify that on the twenty-eighth day of September, A. D. 1939, a mandate was issued out of said Circuit Court of Appeals directed to the United States Board of Tax Appeals.

In Testimony Whereof, I hereunto subscribe my name and affix the seal of the United States Circuit Court of Appeals for the Eighth Circuit, at office in the City of St. Louis, Missouri, this twenty-seventh day of October, A. D. 1939.

E. E. KOCH,
Clerk of the United States Circuit Court of Appeals for the Eighth Circuit.

(Seal)

SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI—March 25, 1940

On petition for writ of certiorari to the United States Circuit Court of Appeals for the Eighth Circuit

A motion for leave to file a petition for rehearing and petition for rehearing having been submitted in this case;

Upon consideration thereof, it is ordered by this Court that the motion for leave to file and petition for rehearing be, and the same are hereby, granted.

And it is further ordered that the order denying certiorari be, and the same is hereby, vacated; and that the petition for writ of certiorari herein be, and the same is hereby, granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

(8674)

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No. [redacted] 8

IN THE

Supreme Court of the United States

October Term, 1939.

CRANE-JOHNSON COMPANY, a corporation of North Dakota,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

JOHN E. HUGHES,
First National Bank Bldg.,
Chicago, Illinois,
Counsel for Petitioner.

U. S. Law Printing Company, 2817 N. Halsted St., Chicago, Ill.

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IN THE

Supreme Court of the United States

October Term, 1939.

CRANE-JOHNSON COMPANY, a corporation of North Dakota,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

The Crane-Johnson Company, a corporation of North Dakota, by John E. Hughes, its attorney, prays that a Writ of *Certiorari* issue to review the judgment of the United States Circuit Court of Appeals for the Eighth Circuit entered in the above-entitled cause on August 8, 1939, affirming a decision of the United States Board of Tax Appeals.

OPINIONS BELOW.

The opinion of the Board of Tax Appeals is published in *38 B. T. A. 1355.* The opinion of the Circuit Court of Appeals is published in *105 F. (2d) 740.*

JURISDICTION.

The judgment below was entered August 8, 1939, and a Petition for Rehearing was denied September 15, 1939 (R. 46). The jurisdiction of this Court is invoked under *Section 240 (a) of the Judicial Code* as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED.

Whether, for the purpose of the credit permitted in the determination of the surtax on undistributed profits under the Revenue Act of 1936, the taxpayer's charter constitutes "a written contract executed by the corporation, which contract expressly deals with the payment of dividends"? If not, whether the taxpayer's stock certificates constitute a written contract executed by the corporation which contract expressly deals with the payment of dividends?

Is the law, as construed by the Court below, so arbitrary and capricious that it violates the *Fifth Amendment,* in classifying the petitioner with others not similarly situated and in discriminating against the petitioner in favor of others who are similarly situated?

To put the question more concretely, the taxpayer's income for 1936 was $13,450.76. It had a capital deficit of $21,251.40. Under North Dakota statutes it could declare dividends only from "surplus profits". There was no surplus but instead an impairment of capital stock. Since it was expressly prohibited by North Dakota statute from distributing any dividend and since the statute constituted

a part of its charter and since the charter was a written contract with the State and its stockholders, taxpayer contends that it was prohibited by the provisions of a written contract expressly dealing with the payment of dividends, from declaring any dividend during the taxable year and hence is literally within the words of the Revenue Law allowing a credit against the undistributed profits tax. The same is true of taxpayer's stock certificate.

STATUTES AND REGULATIONS INVOLVED.

North Dakota Compiled Laws—Supplement—(Annotated), 1913-1925:

"*Sec. 4543. Dividends only from profits; limitations of indebtedness; exceptions.*—The directors of corporations must not make dividends except from the surplus profits arising from the business thereof; nor must they divide, withdraw, or pay to the stockholders, or any of them, any part of the capital stock.***"

REVENUE ACT OF 1936

(U. S. C. Supp. III, Title 26, Sec. 13a):

"*Sec. 14.* Surtax on Undistributed Profits.

(a) *Definitions.*—As used in this title—

* * *

(2) The term 'undistributed net income' means the adjusted net income minus the sum of the dividends paid credit provided in *section 27* and the credit provided in *section 26 (c)*, relating to contracts restricting dividends.

(b) *Imposition of Tax.*— There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in *subsection (c):*

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

* * *"

"*Sec. 26.* Credits Of Corporations. In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * *

(c) *Contracts Restricting Payment of Dividends.*—(1) *Prohibition on Payment of Dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends."

Treasury Regulations 94 (1936 Ed.), promulgated under the Revenue Act of 1936.

"The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of *26 (c).*"

STATEMENT.

The facts in this case were stipulated (R. 12) and the Board found the facts as stipulated (R. 14). It was stipulated that petitioner was incorporated under the statutes of North Dakota, April 29, 1903. That as of January 1, 1936, petitioner had a deficit of at least $21,251.40. There was a surplus in March 1930 (R. 12).[1]

Petitioner's net income from the taxable year was $13,450.76 (R. 12-13). Its adjusted net income was $12,032.72 (R. 13, 14). The Statute of North Dakota expressly forbade its directors to declare any dividend. In its return for 1936 it claimed a credit under *Section 26*

1. It was stipulated that the records prior to January 1, 1929 are not susceptible of analysis to show how the deficit occurred but since there was no deficit in March 1930 and the deficit occurred subsequent to that date, it is immaterial whether the records prior to the time there was a surplus are susceptible of analysis.

(c) (1) of the Revenue Act of 1936 in the computation of the surtax on undistributed profits. The Commissioner disallowed this credit, determined a surtax of $1771.36 on undistributed profits, and asserted a deficiency in that amount (R. 12, 13). The Board of Tax Appeals approved the action of the Commissioner (R. 21-22) and this action was affirmed by the Circuit Court of Appeals (R. 41).

In addition to the other income taxes (a normal tax of from 8 to 15% and an excess profits tax from 6 to 12%) Congress by the Revenue Act of 1936 imposed a special undistributed profits surtax of from 7 to 27% on the portion of earnings which corporations did not distribute as dividends to their stockholders.

It was recognized that in certain cases corporations could not distribute dividends and in such cases a credit was allowed. The provision allowing the credit and which the petitioner claims is applicable in this case is the provision of *26 (c) (1) of the Revenue Act of 1936* allowing a credit in the following language:

> "An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends."

In the case at bar petitioner's adjusted net income was $12,032.17 and since its capital impairment was $21,251.41 there was no excess of adjusted net income which could be distributed as dividends without violating its charter contract and hence we contend its case falls literally within the above quoted statute and it is entitled to the credit thereby allowed.

It was conceded below and must be conceded here that if petitioner's charter constitutes a written contract executed by petitioner containing a provision which expressly deals with the payment of dividends, then the decision of the Court below was wrong and petitioner is entitled to the credit. The same is true if its stock certificate constituted such a contract.

Since petitioner's charter was executed prior to May 1, 1936, the first question in this case is whether it is "a written contract executed by the corporation prior to May 1, 1936" and if so whether it contains a provision which "expressly deals with the payment of dividends".

Petitioner claims that its charter is a written contract between its stockholders, itself and the State, that this charter consists among other things of the express provisions of the State Corporation Law as fully as if it were repeated *verbatim* therein and that the provision of this State Law which the charter contract contains "expressly deals with the payment of dividends". Hence petitioner is entitled to the credit allowed by the above provision of the Revenue Act and is literally within it. * * * Moreover, to deny such credit in this case is to discriminate against the petitioner in favor of other taxpayers which are subject to restrictive contracts and therefore similarly situated with respect to the payment of dividends, in violation of the *Fifth Amendment.*

Petitioner further claims that the surtax on undistributed profits is framed upon the premise that the income to be taxed shall be distributable by the taxpayer corporation, and that it is a violation not only of the taxing law but of the *Fifth Amendment* to impose the surtax on its income which was not distributable.

The regulation promulgated under the 1936 Revenue Act expressly declared that a charter would not be considered a written contract within the above-quoted provision of the law. This regulation, however, has not been approved by the re-enactment of the Statute because the short experience under the undistributed profits tax proved it a failure and it was not re-enacted. Shortly after its promulgation the regulation was questioned by disinterested academic sources. *XII Indiana Law Review 19, 28; 36 Columbia Law Rev. 1343.*

The Board of Tax Appeals held in this case that irrespective of whether the charter was a contract expressly dealing with the payment of dividends, Congress did not intend to embrace it within this provision of the law, because the Revenue Act of 1936, as it passed the House, contained a provision giving relief to ALL deficit corporations and this provision was omitted from the conference draft that became law. However there is nothing in the legislative history showing why it was omitted. Petitioner argued in the Circuit Court of Appeals that this holding was erroneous for the reason that if legislative history could be considered, the provision contained in the House Bill granted relief to ALL deficit corporations, including those existing in States where they might legally declare dividends and the Senate considered this too broad and therefore struck it out, evidently considering that corporations restricted by charter or other contracts from declaring dividends, alone should have relief. (See page 23 annexed brief.) The Circuit Court of Appeals affirmed but on entirely different grounds than that upon which the Board put its decision (R. 41).

The Court held that the North Dakota Statute quoted on page 3 hereof made it the obligation of the Directors and not of the corporation not to declare dividends (R.

43) and that "the corporation itself has made no written contract affecting its right to declare dividends".[2] The opinion seems to hold that the charter is a written contract and again that it is not a written contract (R. 43). Again the Court seems to say that merely because a penalty is imposed on the directors the obligation is theirs alone and not that of the corporation.

The Court did not pass on the contention that the stock certificate was such a contract, although this contention was urged by petitioner. The Court also stated that if there was such contract it was implied, overlooking that the contract upon which we rely is all in writing.

SPECIFICATION OF ERRORS TO BE URGED.

The Circuit Court of Appeals erred:

(1) In failing to hold that petitioner was prohibited from distributing any of its 1936 earnings as dividends because of the provision of the written contract executed by it prior to May 1, 1936, which provision expressly deals with the payment of dividends.

(2) In affirming the order of the Board of Tax Appeals.

(3) In failing to hold that the statute as construed by it was so arbitrary and unreasonable that it violated the *Fifth Amendment.*

REASONS FOR GRANTING THE WRIT.

The question presented by the present case is an important question of federal income tax law and one of wide general importance, not heretofore determined by

2. In another part of its opinion the Court said (R. 42): "The Supreme Court of North Dakota has held that a dividend cannot be rightfully declared by a corporation except out of the profits earned by it and that this principle is embodied in the North Dakota Statutes above referred to. **Ulness v. Dunnell, 237 N. W. 208.**"

this Court and which should be determined by this Court. The question affects all corporations in the United States which had an impairment of capital stock in 1936 and which made any profit in that year. Scores of cases involving this question from all over the country are pending in the Treasury Department before the Board of Tax Appeals and some in the Federal District Courts. It is impossible for there to be a conflict between the United States Circuit Courts of Appeal at this time because this is the first and only case decided by a Circuit Court of Appeals which involves this question. Other taxpayers similarly situated are unwilling to accept the decision of the Court below as sound law and have expressed an intention to continue to litigate their cases and are continuing to litigate them and unless the question is settled by this Court now, great expense will be imposed upon the Government and taxpayers in future litigation involving this question, other petitions for *certiorari* presenting it will be filed and in all probability its settlement by this Court will be merely postponed.

Furthermore, it is submitted the Court below has decided the very important question presented in an untenable way, because it is elementary law that the charter of the corporation is a written contract embracing among its terms the provisions of the State Statutes and the Statutes of North Dakota, as construed by the Supreme Court of the State, expressly prohibited the petitioner declaring dividends. Thus by provision in writing expressly dealing with the payment of dividends, which was a part of its charter, petitioner was restrained from paying the same. The same is true of petitioner's stock certificates.

The decision is further untenable because it gives no consideration to the underlying purpose, reason and intent of the statute and fails to attempt to reconcile this underlying intent with the construction which it gives the statute. The construction of the Court below imputes to Congress an intent to make an indefensible discrimination by allowing rich corporations to avoid the tax, while affording no escape to those in failing circumstances—and this for no reason whatever.[3]

Furthermore, it is submitted the construction adopted by the Court below results in violation of the *Fifth Amendment.* The law by its terms necessarily purports to levy a surtax on income which can be distributed by the taxpayer corporation to its stockholders. Under the construction adopted by the Court below, however, this characteristic of the tax is ignored and no distinction made between distributable and undistributable income, although this taxpayer and numerous other corporations similarly situated could not in fact or in law treat their earnings, if distributed, as income distributable to their stockholders by way of taxable dividends, but only as return of capital. The petitioner is therefore arbitrarily classified with corporations which can distribute their income and are therefore in a materially different situation.

Moreover, the interpretation adopted by the Circuit Court of Appeals permits a rich and prosperous corporation to escape the surtax, provided it happens to have executed a contract restricting payment of dividends, while it does not permit corporations with an impairment of capital stock and on the verge of bankruptcy to escape the tax, notwithstanding they are equally disabled from

3. Compare **Foley Securities Co. v. Commissioner, 106 F. (2d) 731, 735**

distributing their earnings, thus clearly and needlessly resulting in a most arbitrary and unfair discrimination between taxpayers subject to substantially the same disability.

The reasons why the important decision below is untenable are briefly developed in the annexed brief.

Wherefore it is respectfully submitted that this Petition should be granted.

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BRIEF IN SUPPORT OF PETITION.

A statement of the jurisdiction of this Court, a statement of the case and the assignment of errors are set forth in the foregoing petition and not repeated here. It is submitted that the following points, all of which are elementary and undisputed law, clearly sustain the petitioner's case.

POINT I.

THE CHARTER OF A CORPORATION IS A WRITTEN CONTRACT EXECUTED BY THE CORPORATION.

Among the multitude of authorities so holding see, *Dartmouth College v. Woodward (1819), 4 Wheaton 518 (17 U. S. 418), 682-683; Home Building & Loan Assn. v. Blaisdell, 290 U. S. 398, 429, 430; Corporations, 14 C. J., Sec. 162, page 161; 7 Ruling Case Law, Sec. 71, p. 93; Cook on Corporations (8th Edition), Secs. 492-494; Personal Industrial Bankers v. Citizens Budget Co., 80 F. (2d) 327, 328 (C. C. A. 6th).*

Between the decision in the *Dartmouth College case* and the decision in the *Home Building & Loan Assn. case*, numerous decisions of this Court have repeated the doctrine. In *Chenango Bridge Co. v. Binghampton Bridge Co., 70 U. S. 51*, at page *73*, the Court said:

> "We have supposed, if anything was settled by an unbroken course of decisions in the federal and state courts, it was, that an Act of incorporation was a contract between the State and the stockholders. All courts at this day are estopped from questioning the doctrine. The security of property rests upon it, and every successful enterprise is undertaken, in the unshaken belief that it will never be forsaken.
>
> "A departure from it now would involve dangers to society that cannot be foreseen, would shock the sense of justice of the country, unhinge its business inter-

> ess, and weaken, if not destroy, that respect which has always been felt for the Judicial Department of the Government. An attempt even to reaffirm it, could only tend to lessen its force and obligation."

We do not multiply citations but all text books and innumerable decisions of lower federal Courts and of all state Courts have uniformly repeated as elementary law the rule for which we contend. It is a fixed legal principle which was well known to members of Congress.

In the article on the *Undistributed Profits Tax* in *XII Indiana Law Journal 19, at p. 28, apropos* of the section of the income tax law involved here, it is said:

> "That the charter of a corporation is a contract was determined long ago in the famous *Dartmouth College case,* and the charter in the case of the Indiana corporation contains provisions which 'expressly deal with the payment of dividends.' This would seem a sufficient compliance with the requirements of *Subsection 26 (c) (1)* of the Act to entitle the corporation to credit when it is prevented from paying dividends by the terms of its charter."

In the article in *36 Columbia Law Review, page 1343,* it is said:

> "The Treasury has excluded corporate charters from the category of contracts thereby repudiating the traditional definition of a charter as a contract between state and corporations".

Also the charter is a contract executed by the corporation. See the collection of authorities in the *Law of Federal Income Taxation, Paul & Mertens, Vol. III Supplement, Sec. 32:A43.*[4]

---

4. One thing the Legislative History of the Act conclusively shows is that Congress attached no special importance to the word "executed". The Ways and Means Committee referred to a "written contract in existence prior to March 3, 1936". (See Ways and Means Committee Report 2475, 74th Congress, 2nd Session, page 8.) (Boldface ours.) The Senate Finance Committee referred to contracts "entered into prior to March 3, 1936". (Finance Committee Report No. 2156, 74th Congress, 2nd Session, p. 12.) (Boldface ours.) For a definition of the word "executed", see 28 C. J. p. 278. Both the charter and the stock certificates are executed contracts within the meaning of this definition.

POINT II.

THE PROVISIONS OF THE GENERAL CORPORATION LAW OF NORTH DAKOTA WHICH ARE WRITTEN AND EXPRESSLY DEAL WITH THE PAYMENT OF DIVIDENDS, ARE AS MUCH A PART OF SAID CHARTER CONTRACT AS IF THEY WERE SET FORTH THEREIN.

Among the many authorities so holding, see, *Ainsworth v. Southwestern Drug Co., 95 F. (2d) 172, 173 (C. C. A. 5th); Vol. 1, Fletcher's Encyclopedia on Corporations, p. 440, Sec. 226; Home Building & Loan Assn. v. Blaisdell, 290 U. S. 398, 429, 430; In re Hanson's Estate, 159 N. W. 399, 38 So. Dak. 1.*

In *United States v. Quincy, 4 Wallace 535,* the Court said:

> "It is also settled that the laws which subsist at the time and place of the making of a contract, and where it is to be performed, enter into and form a part of it, as if they were expressly referred to or incorporated in its terms. This principle embraces alike those which affect its validity, construction, discharge and enforcement."

Recently in *Lynch v. United States, 292 U. S. 571,* construing a war risk insurance policy, this Court said at page *577:*

> "The terms of these contracts are to be found in part in the policy and in part in the statutes under which they are issued and the regulations promulgated thereunder".

POINT III.

THE STOCK CERTIFICATE OF THE CORPORATION CONSTITUTES A WRITTEN CONTRACT EXECUTED BY IT UNDER ITS SEAL.

In re Culbertson's, 54 F. (2d) 753, 757, (C. C. A. 9); Jones v. Mo. Edison Elec. Co., 144 Fed. 765, 770; Yoakam v. Providence Biltmore Hotel Co., 34 F. (2d) 533, 541; 36 Columbia Law Review, p. 1343.

In *36 Columbia Law Review, page 1343,* where the provision of the law here involved and the regulation is discussed, it is said that the stock certificate satisfies the provisions of the law with reference to a written contract executed by the corporation.[5] See also *50 Harvard Law Review 322,* at page *341.*

It was recognized in the debates in Congress that a stock certificate constituted a written contract within the provisions of the statute involved in this case, as the colloquy between Mr. Vinson, who was in charge of the Bill in the House and another Member shows.[6]

---

5. "But even if it be assumed that there can be no contract with a non-existent entity, an objection which may be met by the theory of novation, the stock certificate which incorporates the terms of the charter, may realistically be viewed as a contract between corporation and shareholder, and therefore within the contemplation of the unqualified statutory term 'contract'." **36 Columbia Law Review 1343.**

6. **80 Congressional Record, part 6, p. 6230,** shows the following:

"Mr. Hollister: 'I am not discussing the debt situation. Let us assume this condition comes into effect with respect to a preferred stock issue * * *. Let us suppose in the preferred stock issue it is provided that in the event dividends are declared of more than a certain amount then certain voting rights will come into effect or certain things will have to happen. Has that been covered in any way?'

Mr. Vinson of Kentucky: 'It seems to me that certainly comes under paragraph 14, the contract provision.'

Mr. Hollister: 'That is not a contract.'

Mr. Vinson: 'Certainly it is a contract.'"

POINT IV.

THE WRITTEN PROVISIONS OF THE STATE LAW EXPRESSLY DEALING WITH THE PAYMENT OF DIVIDENDS ARE AS MUCH A PART OF THE STOCK CERTIFICATE AS IF THEY WERE SET FORTH VERBATIM THEREIN.

The Bureau of Internal Revenue has ruled that where provisions are set forth *verbatim* in a stock certificate restricting the payment of dividends they are within the provisions of the law involved herein and the taxpayers are entitled to a credit *I. T. 3152, C. B. 1938-1, p. 155.* It would be a superfluous and meaningless act to repeat the provisions of a State law in a stock certificate because they are as fully part of it as if they were repeated. The provision of the Revenue Act involved here (see page 4) merely requires the provision of the contract to be written and to "expressly deals with the payment of dividends". This the provision of the State law does. The Revenue Act does not require the provision to be expressed in the stock certificate but only to "expressly deal with the payment of dividends". The word "expressly" modifies the word "deals" and not the word "provision". The provision was required to be express to prevent argument that merely contracting a debt payable during the taxable year required by implication the use of earnings for its payment and not for dividends and to avoid provisions for sinking funds in bond indentures which said nothing about dividends. Not only is the rule that doubts must be resolved in favor of the taxpayer applicable here *(Hassett v. Welch, 303 U. S. 303, 314)*, but it is submitted that Congress could have had no such insubstantial and meaningless distinction in mind in enacting the Revenue Law, that corporations which repeated the words of the law re-

stricting dividends in the certificate or in their articles of incorporation should have relief while those who did not do this meaningless act should not. A law so providing would be senseless. This Court has said that "substance and not form" governs in construing revenue laws and "taxation is eminently practical". The intent, spirit and purpose of the law must be sought. The intent was plainly and reasonably to give relief to corporations which were forbidden to pay dividends. In other words, the law allowed the corporation an option to distribute earnings and not be taxed or not to distribute and be taxed. If a corporation could not take advantage of this option even if it wanted to, justice dictated relief and not a grossly unfair and discriminatory penalty. The Court below erred in declaring the provision was an exemption which should be construed strictly. It was declared in the Committee Reports and in Congress to be a relief provision. *(Senate Report 2156, 74th Congress, 2nd Sess., pp. 12, 13, 15.)* The rule of construction is that relief provisions should be construed liberally to effectuate their purpose. *Old Colony Trust Company v. Commissioner, 301 U. S. 379, 383; Helvering v. Bliss, 293 U. S. 144, 151; Cochran v. Commissioner, 78 F. (2d) 176, 179 (C. C. A. 4); In re Johnston, 33 B. T. A. 551, 553.* In *Kelly Springfield Tire Co. v. United States, 81 F. (2d) 533, 535 (C. C. A. 3)*, the Court quoted with approval the following statement of the Court of Claims:

> "When a privilege or concession is granted, as in this statute, it is the duty of the court to give the largest and broadest construction in favor of the concession, which the language used will allow in order to afford the relief which the context indicates was intended."

Even if we assume the provision is in the nature of an exemption, still it should not be strictly construed against the taxpayer because it was granted for motives of public policy and to harmonize with State law prohibiting dividends. In such case its construction should be liberal. Compare *U. S. v. Merchants National Trust & Savings Bank, 101 F. (2d) 399, 404 (C. C. A. 9); Roche's Beach Inc., v. Commissioner, 96 F. (2d) 776, 779 (C. C. A. 2); Helvering v. Bliss, 293 U. S. 144, 151.*

POINT V.

PETITIONER'S CHARTER CONTRACT EXPRESSLY FORBADE IT TO DECLARE A DIVIDEND IN 1936.

The statute of North Dakota declared:

> "The directors of corporations must not make dividends except from the surplus profits derived from the business thereof nor must they divide, withdraw, nor pay to the stockholders or any of them, any part of the capital stock."

Under the statute no dividends might have been declared in the case at bar in the year 1936 because after the earnings for that year there was still a deficit. *Ulness v. Dunnell, 61 N. D. 95; 237 N. W. 208.*[7]

This Court has said that surplus is what remains after deducting all liabilities, including the capital stock. *Hel-*

7. In **Ulness v. Dunnell, 61 N. D. 95,** at pages **99, 100,** the Court said: "It is a well-settled principle that a dividend cannot rightfully be declared by a corporation except out of the profits earned by it: **6 Fletcher, Cyc. Corp., pp. 6209, et seq.; Fricke v. Angemeier, 53 Ind. App. 140; 101 N. E. 321.** In this state the principle is embodied in statute." * * * As noted by the Circuit Court of Appeals in its opinion, the prohibition of the statute itself rests upon the directors. It is, however, apparent from the foregoing language that the Supreme Court of North Dakota has construed the North Dakota statute as binding the corporation, which appears in any event to be the only conclusion which can logically be reached. Directors are the agents of the corporation. **3 Fletcher Cyclopedia of Corporations (Permanent Edition) Section 888.** Obviously the corporation, their principal, will be bound itself by such a statutory limitation upon their actions in a matter in which they alone can act as such agents, since it is only through its agents that the corporation can act at all.

vering v. Canfield, 291 U. S. 163, 166; Willcuts v. Milton Dairy Co., 275 U. S. 215, 218. See also *Edwards v. Douglas, 269 U. S. 204, 214.*

This is the uniform definition of it under statutes of the character above-quoted.

POINT VI.

IMPOSITION OF THE SURTAX ON INCOME WHICH IS NOT DISTRIBUTABLE VIOLATES BOTH THE TAXING STATUTE AND THE FIFTH AMENDMENT.

Under *Section 14 (b)* the surtax is measured only by the *undistributed* net income, which by the differentiation implicit in the use of the word "undistributed" inescapably implies the possibility of distribution. It is impossible to avod the conclusion that *the income in question, to be considered for surtax purposes at all, must be distributable;* otherwise the tax would not be an undistributed profits tax but merely an income tax. To say, therefore, that the tax shall be imposed on undistributed income which *could not be distributed* is thoroughly inconsistent with the theory of the tax itself, an illogical construction which should not be permitted.

That the 1936 income of the petitioner was not distributable income is easily demonstrated. The laws of North Dakota, as above mentioned under Point V, prohibit distribution of dividends except from surplus profits arising from the business. In the face of the continuing capital deficit in 1936, any distribution by the petitioner to its stockholders would necessarily have been an encroachment upon capital and consequently a distribution not of "surplus profits", but of capital. Such a distribution would not constitute taxable income in the hands of the

stockholders[8] and, therefore, the petitioner would be denied any dividends paid credit for such distribution, since *Section 27 (h) of the Revenue Act of 1936* prohibits a dividends paid credit for any part of a distribution which is not a taxable dividend in the hands of stockholders.

Consequently, it is evident that the earnings of this corporation in 1936 did not constitute net income in its hands distributable as income and that therefore the tax imposed by *Section 14* cannot, under any reasonable construction of the statute, apply thereto. The decision below, however, would arbitrarily bring this petitioner and other deficit corporations under this surtax which, by its terms, should not apply to them. In so doing, it offends against the *Fifth Amendment* by unreasonably classifying such corporations with others which are differently situated with respect to the one essential fact upon which the incidence of the surtax turns.

POINT VII.

THE DECISION BELOW DISCRIMINATES AGAINST THE PETITIONER IN FAVOR OF OTHERS SIMILARLY SITUATED, IN VIOLATION OF THE FIFTH AMENDMENT.

It is axiomatic that discrimination in legislation, including tax legislation, must be based upon some reasonable basis of classification if it is not to be condemned as arbitrary and confiscatory under the *Fifth Amendment*. We submit that there exists no reasonable difference between "deficit corporations", forbidden by charter and state law to pay dividends, and corporations having contracts restricting dividends, which would justify discrimination between the two classes with respect to liability for surtax on undistributed profits.

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8. **Hadden v. Commissioner, 49 F. (2d) 709 (C. C. A. 2); Helvering v. Canfield, 291 U. S. 163, 166.**

It was clearly the intent of Congress in imposing the tax to penalize, or at least tax, the retention of corporate income. In the case of corporations which were unable so to distribute income, Congress attempted to provide legislative relief under *Section 26 (c) of the Revenue Act of 1936*. The beneficiaries of that relief provision were corporations which had contracts preventing the payment of dividends or contracts which tied up current income for the purpose of payment of or provision for previous indebtedness. The manifest purpose was to avoid the injustice which would result in the case of corporations which, by reason of definite, preexisting obligations, could not obtain the dividends paid credit under *Section 27*.

From the viewpoint of distribution of income by way of dividends, however, which the statute itself makes the controlling factor, there is absolutely no relevant observable difference between corporations subject to restrictive contracts and corporations which are subject to charter contract restrictions imposed by state law by reason of an existing impairment of their capital. Corporations of both types, in the absence of *Section 26 (c)*, would be faced with the identical factual problem of being unable legally to distribute income by way of dividends and yet being taxed for not distributing such income. To say that one class shall have the benefit of the relief accorded by *Section 26 (c)*, and that the other class shall not (although the only difference is the unsignificant fact that one restriction results from an ordinary contract and the other from a special contract embodied in the corporate charter and applicable state law), is a violation of the *Fifth Amendment* by arbitrary discrimination without any reasonable factual basis. It is also a disregard of the intent and spirit of the Statute.

It is our contention that the charter in the present case constitutes a contract within the plain meaning of *Section 26 (c)*. If, however, such is not the case, then the Revenue Act of 1936 is fatally defective in so far as the partial relief of *Section 26 (c)* results in unjustified and unconstitutional discrimination. Certainly, sufficient doubt is raised on constitutional grounds to bring the decision of the Court below within the rule which has many times been stated by this Court and is thus expressed by Mr. Justice Holmes in *United States v. Jim Fuey Moy, 241 U. S. 394, 401:*

> "A statute must be construed, if fairly possible, so as to avoid not only the conclusion that it is unconstitutional, but also grave doubts upon that score. *United States ex rel. Atty. Gen. v. Delaware & H. Co., 213 U. S. 366, 408, 53 L. Ed. 836, 849, 29 Sup. Ct. Rep. 527.*"

POINT VIII.

THE LEGISLATIVE HISTORY AND INTENT AND SPIRIT OF THE STATUTE SUPPORT PETITIONER.

The Board of Tax Appeals held that because the House Bill contained a provision which would have given all deficit corporations relief and it did not appear in the Bill as amended by the Finance Committee of the Senate, it necessarily followed Congress did not intend to grant relief to deficit corporations in states where they could not legally declare dividends. This does not follow. The legislative history does not show the reason the provision was stricken. *Non constat* it was stricken because the Senate did not desire to grant relief to deficit corporations in those states where they could legally declare dividends and thus were under no contractual obligations not to do so. It was said in debates in the Senate that 36 states imposed limitations on the declaration of divi-

dends by corporations with an impairment of capital stock. *(Con. Rec. Vol. 80, Part 8, p. 9058.)* There were 12 states in which deficit corporations might legally declare dividends. Moreover the laws of the 36 states which prohibited dividends in some form did not all prohibit dividends where the capital stock was impaired.[9]

The legislative history supports our contention that most of the Members of Congress who were lawyers understood the traditional concept of a corporate charter as a contract was embraced within the contract provision upon which we rely. For example, Senator Walsh, a member of the Finance Committee, made a speech against the Bill wherein he stated there was no relief afforded by the Senate Bill to corporations having an impairment of capital stock. *(Con. Rec. 80, Part 8, p. 9058.)* After this speech and after the Senate Bill had been rewritten in conference in the form in which it was enacted, Senator Walsh was apparently told that he was wrong and that his objection was untenable because in the Senate Minority Report on the Conference Bill, June 19, 1936 *(80 Cong. Rec. Part 10, p. 10164)* signed by Senators Walsh and George, the following appears:

> "The defenders of the bill in the form which it has now taken contend that by sundry exemptions and modifications the smallest corporations are spared the full force of the new tax as well as helped by the lowering of the rates on the normal income tax; that the banks and insurance companies are entirely excluded; and that in some instances corporations under

9. In a group of states, including California and Delaware, corporations might pay dividends so long as the net assets were not reduced below the stated value of the preferred stock, albeit such dividends impaired the common stock, provided they were paid out of net earnings for the year. An Iowa corporation might pay dividends so long as its assets exceeded its liabilities to others than its stockholders. **(House Hearings, pp. 846, 847.)** See **23 California Law Review, 229. Theory of Anglo American Dividend Law, 28 Col. L. R. 1046; 29 Col. L. R. 461; 30 Col. L. R. 380, 954.**

contract not to pay dividends, *and forbidden by law to do so,* are permitted without extra penalties to apply a percentage of their earnings to reserve."[10] (Italics ours.)

The purpose, intent and underlying spirit of the law was to prevent rich men avoiding taxes by accumulating large earnings in corporations which they controlled. (See President's Message in *House Report No. 2475, 74th Cong., 2nd Sess.)* See also examination of witness by Senator Black. *Senate Hearings, pages 265 to 268. Sanford v. Commissioner, 106 F. (2d) 882, 884.*

Stockholders of a corporation, the capital of which was impaired, would not be taxable on distribution made out of capital. *Hadden v. Commissioner, 49 F. (2d) 709 (C. C. A. 2).* Such stockholders upon return of their capital might even have a loss deductible from other income and which would serve to reduce their taxes. The purpose of the law was to force taxable dividends into the hands of stockholders. A return of capital cannot be made taxable income by law. Also, as pointed out on page 21 hereof, a distribution was required to be taxable to a shareholder before a corporation could take credit for it.

Congress certainly could not have intended to permit rich and prosperous corporations to avoid this special surtax and to take that privilege away from deficit corporations and penalize them for being unsuccessful.

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10. It should be noted that this was a report on the final Bill which became law. The preceding bills passing the House and Senate were different from this. As said in the supplement to the **Law of Income Taxation, Paul & Mertens, par. 32A-05:** "The House and Senate 1936 Bills were dissimilar in general aim, theory and in structure. The 1936 Act, as finally enacted, was to a considerable extent written in conference without any new statement of legislative intent—a fact which contributes in no small measure to the difficulty of interpretation of the Act."

To impose a heavier tax on a corporation with impaired capital stock than on a rich corporation with a surplus would be to ruin the corporation in failing circumstances and promote the prosperous one. Yet, under the construction of the Court below that is what the law does. This construction is at variance with the underlying purpose, spirit and intent of the Act which the Court below wholly ignored and is untenable tested from any angle.

For the foregoing reasons the Writ of *Certiorari* should be granted.

All of which is respectfully submitted.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1940.

No. 8

CRANE-JOHNSON COMPANY, a corporation of North Dakota,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF FOR PETITIONER.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1940.

No. 8

CRANE-JOHNSON COMPANY, a corporation of North Dakota,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF FOR PETITIONER.

OPINIONS BELOW.

The opinion of the Board of Tax Appeals (R. 14) is reported in 38 B. T. A. 1355. The opinion of the Circuit Court of Appeals (R. 41) is reported in 105 F. (2d) 740.

Jurisdiction.

The judgment of the Court below was entered August 8, 1939 (R. 45). A petition for rehearing was denied below

September 15, 1939 (R. 46). The petition for the writ of certiorari was filed December 12, 1939 and granted March 25, 1940. The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

Questions Presented.

The adjusted net income of the petitioner for the calendar year 1936 was $12,032.72. As of January 1, 1936 the petitioner had a capital deficit of at least $21,251.40. No dividend was declared during the year and no dividend could be declared because a North Dakota Statute (Appendix, p. 49) prohibited the corporation paying dividends except from surplus profits arising from the corporation's business and there was no surplus but a deficit.

The questions presented are:

1. Whether, for the purpose of the relief granted in the determination of the surtax on undistributed profits under the Revenue Act of 1936, the taxpayer's charter constitutes "a written contract executed by the corporation," part of the provisions of which consists of the general corporation law of North Dakota? If not, whether the taxpayer's stock certificate constitutes a written contract executed by the corporation part of the provisions of which is the general corporation law of North Dakota?

2. Is the law, as construed by the Court below, of such doubtful constitutionality as to warrant the Court in construing it so as to avoid the doubt?

3. Did the Court below fail to apply established rules for the construction of taxing Statutes and reach its decision by the application of contrary rules?

Statutes and Regulations Involved.

Pertinent statutes and regulations are set forth in the appendix, *infra*, p. 49.

STATEMENT.

In the case at bar certiorari was granted because of direct conflict with *Northwest Steel Rolling Mills, Inc.* v. *Commissioner*, 110 F. (2d) 286 (C. C. A. 9). The amount of tax involved is $1,707.36.

The facts in this case were stipulated (R. 12) and the Board found the facts as stipulated (R. 14). It was stipulated that petitioner was incorporated under the statutes of North Dakota, April 29, 1903. That as of January 1, 1936, petitioner had a deficit of at least $21,251.40. There was a surplus in March, 1930 (R. 12)[1] so this deficit was incurred after that date.

Petitioner's net income for the taxable year 1936 was $13,450.76 (R. 12-13). Its adjusted net income was $12,-032.72 (R. 13, 14). The statute of North Dakota expressly forbade its directors to declare any dividend in 1936 because its capital was impaired and none was declared. As stated by the Court below the State Supreme Court has construed this statute to forbid dividends (R. 42).

[1] In his brief in opposition to the petition for certiorari on page 14 thereof, respondent stresses a statement in the stipulation that the records prior to 1929 are not susceptible of analysis to show how the deficit occurred. But the stipulation also shows that there was a surplus in March, 1930 (R. 12, Par. 4). In view of this the stipulated deficit did not occur prior to January, 1929 but subsequent to March, 1930. Hence it is of no consequence that the records prior to 1929 are not susceptible of analysis and there is nothing to this argument of respondent. Since under the North Dakota statute a dividend cannot be declared except from surplus and since a deficit is the converse of a surplus and the existence of a deficit was stipulated, it is clear that no dividend could be declared and both Tribunals below decided the case on this basis.

In its return for 1936, petitioner claimed a credit under Section 26 (c) (1) of the Revenue Act of 1936 in the computation of the surtax on undistributed profits. The Commissioner disallowed this credit, determined a surtax of $1,771.36 on undistributed profits, and asserted a deficiency in that amount (R. 12, 13). The Board of Tax Appeals approved the action of the Commissioner relying wholly on legislative history (R. 14-22) and this action was affirmed by the Circuit Court of Appeals (R. 41) but on entirely different grounds.

In addition to the other income taxes (a normal tax of from 8 to 15 per cent and an excess profits tax from 6 to 12 per cent) Congress by the Revenue Act of 1936 imposed a special undistributed profits surtax of from 7 to 27 per cent on the portion of earnings which corporations did not distribute as dividends to their stockholders. The law was designed to permit corporations to avoid this special tax by distributing their earnings. Its purpose was to prevent rich men avoiding the high personal surtax by accumulating money in corporations they controlled, the corporate rate being lower than the high individual surtax.

It was recognized by Congress that in certain cases corporations could not distribute dividends, albeit they might desire to do so, and in such cases to prevent discrimination in favor of corporations able to pay dividends a credit was allowed. The provision allowing credit in such case and which the petitioner claims is applicable in this case is the provision of 26 (c) (1) of the Revenue Act of 1936 in the following language:

> "An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends."

In the case at bar petitioner's adjusted net income for 1936 was $12,032.17 and since its capital impairment was at the beginning of the year, $21,271.41, there was no excess of adjusted net income which could be distributed as dividends without violating the provision of its written charter contract and its stock certificate, which contained the state law expressly dealing with the payment of dividends, and hence we contend its case falls literally within the above quoted statute and that accordingly it is entitled to the credit thereby allowed.

It was conceded below and must be conceded here that if petitioner's charter constitutes a written contract executed by petitioner which contract contains a provision which expressly deals with the payment of dividends, then petitioner's case falls literally within the statute and the decision of the Court below was wrong and petitioner is entitled to the credit. The same is true if its stock certificate constituted such a contract. The Court below ignored this last point about the stock certificate, although petitioner urged it in brief and oral argument.

Since petitioner's charter was executed prior to May 1, 1936 and in April, 1903, the statutory requirement of execution prior to May 1, 1936 is met and the first question in this case is whether the charter is "a written contract executed by the corporation" and if so whether this contract contains the State Corporation Law which law concededly contains a provision which "expressly deals with the payment of dividends." If not then is the stock certificate such a contract?

Petitioner claims that its charter is a written contract between its stockholders, itself and the State, that the Court below correctly said this charter consists among

other things of the express provisions of the State Corporation Law to the same extent as if it had been actually printed in the charter and that the provision of this State law, which the charter contract contains, "expressly deals with the payment of dividends." If this contract was "executed" by it petitioner is entitled to the credit allowed by the above provision of the Revenue Act and is literally within it. * * * Moreover, it is claimed to deny such credit in this case is to discriminate against the petitioner in favor of other taxpayers which are subject to other restrictive contracts and therefore similarly situated with respect to the payment of dividends, in violation of the Fifth Amendment. It is also to create indispensable discrimination by giving a rich corporation an option to avoid the tax and none to a poor corporation tottering on the verge of insolvency.

Petitioner further claims that the surtax on undistributed profits is framed upon the premise that the income to be taxed shall be distributable by the taxpayer corporation, and that it is a violation not only of the design of the taxing law but also of the Fifth Amendment to impose the surtax on its income which was not distributable. It claims the law did not intend to penalize failure to do an act the doing of which was illegal.

The Treasury regulation (Art. 26-2, Reg. 94) promulgated under the 1936 Revenue Act expressly declared that a charter would not be considered a written contract within the above-quoted provision of the law. It said nothing about a stock certificate. This regulation, however, has not been approved by the re-enactment of the statute because the short experience under the undistributed profits tax proved it a failure and it was not re-

enacted, the result it sought to accomplish being attainable in other ways.* Shortly after its promulgation the regulation was questioned by disinterested academic sources, XII Indiana Law Review 19, 28; 36 Columbia Law Rev. 1343, 85 U. of Penn. Law Review 89, and has been continually questioned since.

Basis of Board of Tax Appeals Decision.

The Board of Tax Appeals held in this case (see its Opinion, R. 14) that irrespective of whether the charter was a contract executed by petitioner expressly dealing with the payment of dividends the legislative history of the statutory provision involved showed Congress did not intend to embrace such contract within this provision of the law solely because the Revenue Act of 1936, as it passed the House, contained a provision giving relief to ALL deficit corporations including those not forbidden to declare dividends and this provision was omitted in the Senate bill and by the conference draft (differing radically from both House and Senate bills) that became law. Concededly there is nothing in the legislative history showing why it was omitted. Petitioner argued in the Circuit Court of Appeals that this reasoning of the Board was palpably erroneous for the reason that, if legislative history could be considered, the provision contained in the House bill granted relief to all deficit corporations, including those existing in states where they might legally declare dividends and the Senate considered this too broad and therefore struck it out, evidently considering that corporations restricted by contract from declaring dividends, alone should have relief, and that those free to distribute dividends were not entitled to relief. (See R. pp. 26, 27.) The Board also stressed that the Senate changed the definition of a dividend to afford relief to deficit cor-

*The effect of this regulation is discussed at page 21.

porations which did distribute dividends. However, this change was necessary to afford relief to deficit corporations which did distribute dividends in the twelve states where they might lawfully do so, otherwise such corporations would not have been entitled to any credit for a dividend distribution because it would not be taxable to the stockholders. In changing this definition Congress did not have in mind corporations which could not distribute dividends. If it did it would be saying to them, "if you violate state law we will allow you a tax credit." Of course it had no intent so to do.

Basis of Opinion of Court Below.

The Circuit Court of Appeals considered the aforesaid objections to the Board's decision and affirmed but on an entirely different ground than that upon which the Board put its decision (R. 41). The ground of the decision of the Circuit Court of Appeals was, (1) "The corporation itself has made no written contract affecting its right to declare dividends," and (2) "If there is such a contract, it is not an express one, but is implied."

After considering this opinion of the Court below the Circuit Court of Appeals for the 9th Circuit in a later case rejected it as unsound, saying "it confuses the wording of the statute." 110 F. (2d) 286, 289.*

The Court below entirely ignored our contention that the stock certificate was a contract executed by the corporation and complied with the words of the Revenue Law allowing a credit.

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*It is respectfully submitted that the opinion confuses more than the wording of the statute. It confuses the distinction between an express and an implied contract. Section 5884 of the Civil Code of North Dakota defines an express contract as follows: "An express contract is one the terms of which are stated in words."

Specification of Errors to Be Urged.

The Circuit Court of Appeals erred:

1. In failing to hold that petitioner was prohibited from distributing any of its 1936 earnings as dividends because of a written contract executed by it prior to May 1, 1936, which contract contains a provision expressly dealing with the payment of dividends.

2. In affirming the order of the Board of Tax Appeals.

3. In failing to hold that the statute as construed by it was so arbitrary and unreasonable that it violated the Fifth Amendment.

Summary of Argument.

Petitioner's charter and stock certificates were issued in 1903 and if executed by petitioner they comply with the provision of the statute requiring execution prior to May 1, 1936.

The first point we make the Court below conceded. It is that the statute of North Dakota expressly prohibited a corporation without a surplus distributing any of its earnings in dividends and allowed dividends to be made only out of surplus and that it had been so construed by the North Dakota Supreme Court. The Court below correctly stated (R. 41, 42):

> "Sec. 4543 of the North Dakota Compiled Laws of 1913 provides that: 'The directors of corporations must not make dividends except from the surplus profits arising from the business thereof; nor must they divide, withdraw, pay to the stockholders, or any of them, any part of the capital stock.''

Again the Court below correctly declared in its opinion (R. 42):

> "The Supreme Court of North Dakota has held that a dividend can not rightfully be declared by a corporation except out of the profits earned by it and that this principle is embodied in the North Dakota statutes above referred to. *Ulness* v. *Dunnell* (N. D.) 237 N. W. 208. Similar statutory provisions were in existence when petitioner was incorporated."

The construction of this state statute by the North Dakota Supreme Court is of course binding on all the Federal Courts. *Erie R. Co.* v. *Tompkins,* 304 U. S. 64. Besides, the state statute is so clear as not to require construction.

The second point we make is that the words of the above quoted statute of North Dakota, which concededly expressly deal with the payment of dividends, are a part of petitioner's charter and the Court below also conceded this. The Court below correctly said petitioner's charter included "as it doubtless does, the North Dakota statutes" (R. 42). Again the Court below said:

> "The charter of a corporation organized under general law consists of its articles of incorporation and the laws applicable thereto." (R. 43).

The balance of the argument for petitioner may be summarized in the following five points, all of which are sustained by unanimous authority and none of which we submit can be denied: (1) A corporation stock certificate is in writing. (2) It is a contract. (3) If the word "executed" as used in the statute is held to mean "signed" then a stock certificate is signed by the corporation under its seal. (4) It contains the written provision of the State Corporation Law as fully as if that provision were recop-

ied verbatim therein; and (5) This provision of the State Corporation Law expressly deals with the payment of dividends and prohibits such payment.

If the above five points are true (and we submit they are) the petitioner is literally within the statute and is entitled to the credit.

The legislative history set forth at page 28 hereof shows Congress intended stock certificate contracts to be embraced within this statutory provision. The rulings of the Treasury Department cited on page 28 hereof show that if the provision of State law dealing with dividends had been recopied into the stock certificate the respondent would have conceded the credit, yet this State law is as fully and to the identical extent a part of the stock certificate as if it were recopied therein. Substance and not form is controlling in tax cases. To recopy it in the certificate would add nothing. To construe the law as granting the credit in one case and not in the other results in an absurdity and also renders the Statute unconstitutional. See *Miller* v. *Nut Margarine Co.*, 284 U. S. 498, 510.

The quotations on page 31 hereof from the impartial law reviews of our leading law schools (Harvard, Yale, Columbia, University of Pennsylvania) agree with petitioner that the stock certificate complies with the statute.

In addition to the foregoing we also submit that none of the following points can be denied: (1) The corporate charter is a contract. (2) It is in writing. (3) It includes the written provision of the State law which expressly deals with the payment of dividends and prohibits them. The Court below conceded this point but denied point (1).

We submit the only point that can be reasonably disputed is whether the charter is "executed" by the corporation. We submit when the corporation accepted it in 1903 and began to act under it, it thereby became a party thereto and executed the same. It has continued to operate under this charter for 37 years. "Charters of private corporations are regarded as executed contracts between the government and the corporators," *Pennsylvania College cases,* 13 Wall. 190, 212. The word "executed" is contained in a relief provision and the uniform rule for the construction of such a provision is that it is to be construed liberally. This must be coupled with the other rule that doubts in the construction of tax statutes must be resolved against the government and in favor of the taxpayer. Furthermore the legislative history shows Congress attached no hypertechnical meaning to the word "executed" and that the proponents of the legislation in the Conference Committee, which wrote the law before the Court, stated it granted relief to corporations forbidden by law to declare dividends. No provision of the law could do this except the one before the Court.

Also the spirit and purpose of the statute supports the construction for which petitioner contends. Its purpose was to force rich men accumulating money in corporations (for the purpose of taking advantage of lower corporate taxes and avoiding the higher individual surtaxes) to distribute the corporate earnings and pay taxes on such earnings. (See speech of Senator Black, 80 Cong. Rec., pp. 8813 and 8814). If a corporation without any surplus distributed a dividend out of its capital such dividend, being a return of capital, would not be taxable and if the capital was impaired the stockholder receiving the distribution would have a loss deductible from his other income and thus be able to reduce the taxes on his other

income. It was a penalty on the failure to declare dividends but surely Congress did not intend to penalize failure to do an act, which could not be done without violating state civil and criminal law and which, even if done, would not produce the result Congress enacted the law to bring about but an opposite result. A dividend by a deficit corporation would reduce the taxes payable by a rich stockholder.

It is not necessary for petitioner to convince the Court that the law as construed by the Court below is unconstitutional, but only to show that there is grave doubt about its constitutionality in order for this Court to construe it to avoid the doubt. Other Tribunals called upon to construe it have expressly stated that they were in doubt about its constitutionality if the construction contended for by respondent was the correct one. Thus the Circuit Court of Appeals for the Ninth Circuit stated in 110 F. (2d) at p. 290:

> "There seems to be grave doubts as to whether there is a reasonable basis for discrimination between a written contract actually 'signed' by a corporation prohibiting the payment of dividends, and the contract of the charter to which the corporation is as fully bound, likewise prohibiting the distribution of profits."

The Board of Tax Appeals stated in *Prudential Tobacco Co.*, 42 B. T. A. No. 80:

> "We are not entirely free from doubt upon the present question."

The law as construed by the Court below, puts a premium on the violation of the criminal and civil law of the several states; allows a rich and prosperous corporation an election to avoid the tax and none to the poor tottering corporation; by imposing burdens on the poor not imposed

on the rich it tends to destroy the poor corporation and leave its business to the rich one and thus creates monopoly which is against the statutory policy of the United States; it makes a baseless distinction between charter contracts and all other contracts and it does not operate with geographical uniformity within the United States because it gives deficit corporations incorporated under the laws of 12 states an election to avoid the tax and none to those incorporated under the laws of the other 36 states. Also it does not tax certain corporations situated the same as those it taxes.

ARGUMENT.

Point I.

The North Dakota Statute Expressly Prohibited Petitioner Declaring a Dividend.

Section 5884 of the Civil Code of North Dakota contains the standard definition of an express contract which is as follows:

> "An express contract is one the terms of which are stated in words."

The first point we make is that the express words of the North Dakota statute quoted on page 9 and in the Appendix at page 49 plainly and expressly prohibit a corporation without a surplus distributing a dividend. The Supreme Court of North Dakota has so construed this statute in *Ulness* v. *Dunnell*, 61 N. D. 95.

In that case the highest Court in North Dakota said at page 100:

> "It is a well settled principle that a dividend can not rightfully be declared by a corporation except out of profits earned by it. 6 Fletcher Cyc. pp. 6209 *et seq.*, *Fricke* v. *Angemeir*, 53 Ind. App. 140; 101 N. E. 321. In this state the principle is embodied in statute."*

As heretofore pointed out, in the quotations from the opinion of the Court below on page 10 of the Summary of Argument, the Court below conceded that the North Dakota statute had been construed by the State Supreme

*See the decision of this Court in **Mobile & O. R. Co. v. Tenn.**, 153 U. S. 486, 496. See also Vol. 11, Fletchers Cyc. of Corp., p. 838, Sec. 5335. Surplus is what remains after deducting all liabilities including the capital stock. **Helvering v. Canfield**, 291 U. S. 163, 166. **Willcuts v. Milton Dairy Co.**, 275 U. S. 215, 218; **Edwards v. Douglas**, 269 U. S. 204, 214.

Court to prohibit dividends and that petitioner's charter included "as it doubtless does the North Dakota Statutes." That the North Dakota Statute deals with the payment of dividends in express words and prohibits them being distributed except from surplus is beyond question. The stipulation shows no surplus, but expressly stipulates a deficit exists. Hence there was nothing from which petitioner could declare a dividend. In *Kinnear* v. *Commissioner,* 36 B. T. A. 153, the Board said at page 155:

> "The rule is that a corporation does not have earnings or profits available for distribution as dividends until impairments of capital or paid-in surplus resulting from operating losses have been restored. *Willcuts* v. *Milton Dairy Co.,* 275 U. S. 215; *Crystal Ice Co.,* 14 B. T. A. 682; *Arthur C. Stifel,* 29 B. T. A. 1145; *Louise Glassell Shorb,* 22 B. T. A. 644; *Loren D. Sale,* 35 B. T. A. 938. This rule is recognized by the Commissioner. G. C. M. 1552, C. B. VI-1, p. 10."

In *Foley Securities Co.* v. *Commissioner,* 106 F. (2d) 731, 732, 733, the Court quoted the above statement of the Board with approval and stated it was the uniform rule for income tax purposes.

Point II.

The Aforesaid State Statute Expressly Dealing With Dividends Is a Provision of Petitioner's Charter to the Same Extent As If It Were Recopied Therein.

That this statute is part of petitioner's charter can hardly be disputed and the Court below so held.

This Court and all others have repeatedly declared that the laws which exist at the time of the making of a contract become as much a part of it as if they were recopied therein. In the case of *Northwest Steel Rolling Mills* v. *Commissioner,* 110 F. (2d) 286 at p. 289, the Circuit Court

of Appeals for the 9th Circuit applied this principle to the same situation as the case at bar and quoted the unequivocal language of this Court as follows:

> "(4) It is settled law that: 'Laws which subsist at the time and place of the making of a contract, and where it is to be performed, enter into and form a part of it, as fully as if they had been expressly referred to or incorporated in its terms. *Farmers' Bank* v. *Federal Reserve Bank*, 262 U. S. 649, 660, 43 S. Ct. 651, 655, 67 L. Ed. 1157, 30 A. L. R. 635. See also *Von Hoffman* v. *Quincy*, 4 Wall 535, 550, 18 L. Ed. 403."

This principle has been stated many times in the hornbooks and in decided cases. *Northern P. R. Co.* v. *Wall*, 241 U. S. 87, 91. For its statement and application to corporate charters see Vol. 1, Fletchers Cyc. Corp., p. 440, Sec. 226. Also Vol. 2, Chap. 20, Sec. 765, p. 1736.

In *Ainsworth* v. *Southwestern Drug Co.*, 95 F. (2d) 172 (C. C. A. 5) the Court said at page 173:

> "Appellant argues that the charter and by laws of a corporation constitute a contract between a company and its stockholders into which the statutes of the State of its incorporation enter and are controlling. This may be conceded without discussion."

If the lawyer who incorporated petitioner had taken the trouble to recopy the state law into its Articles of Incorporation respondent would still not have conceded petitioner was entitled to the credit. This is because he claims the charter contract is not "executed" by the corporation.

Point III.

The Charter of Petitioner Corporation Is In Writing. It Is a Contract.

Among the multitude of authorities holding a corporate charter is a contract, see *Dartmouth College* v. *Woodward* (1819), 4 Wheaton 518 (17 U. S. 418) 628-683; *Home Building & Loan Assn.* v. *Blaisdell,* 290 U. S. 398, 429, 430; Corporations, 18 C. J. S., Sec. 71, p. 456; Corporations, 14 C. J., Sec. 162, p. 161; 7 Ruling Case Law, Sec. 71, p. 93; Cook on Corporations (8th Edition), Secs. 492-494; *Personal Industrial Bankers* v. *Citizens Budget Co.,* 80 F. (2d) 327, 328 (C. C. A. 6th) cer. den. 298 U. S. 674. The charter is a contract and it is in writing. Hence it is a "written contract."

Between the decision of this Court in the *Dartmouth College case* and its decision in the *Home Building & Loan Assn. case,* numerous decisions of this Court have repeated the doctrine that a corporate charter is a contract. In *Chenango Bridge Co.* v. *Binghampton Bridge Co.,* 70 U. S. 51, at p. 73, the Court said:

> "We have supposed, if anything was settled by an unbroken course of decisions in the federal and state courts, it was, that an Act of incorporation was a contract between the State and the stockholders. All courts at this day are estopped from questioning the doctrine. The security of property rests upon it, and every successful enterprise is undertaken, in the unshaken belief that it will never be forsaken.
>
> "A departure from it now would involve dangers to society that cannot be forseen, would shock the sense of justice of the country, unhinge its business interests, and weaken, if not destroy, that respect which has always been felt for the Judicial Department of the Government. An attempt even to reaffirm it, could only tend to lessen its force and obligation."

We do not multiply citations but all text books and innumerable decisions of lower Federal Courts and of all State Courts have uniformly repeated as elementary law the rule for which we contend. It is a fixed elementary legal principle which was well known to most members of the Congress. The Court will take judicial notice that most of them were lawyers and familiar with this elementary rule. As said in Corporations, 13 Am. Jurisprudence, Sec. 77, p. 220, of the *Dartmouth College case*:

> "This decision has received unanimous approval by the courts and has been followed and cited many times."

This elementary rule which the Court below ignored is thus stated in 14 C. J. 161, Sec. 162:

> "The charter of a corporation, whether it is created by a special act or formed under a general corporation law, is a contract between the corporation, or the corporators or members, and the state. It is a contract between the state and the corporation, between the corporation and the stockholders, and between the stockholders and the state."

In *Personal Industrial Bankers* v. *Citizens Budget Co.*, 80 F. (2d) 327 (C. C. A. 6), cer. den. 298 U. S. 674, the Court said at page 328:

> "We are here asked to construe a contract, for it is too elementary to require a citation and the parties agree that a corporation charter is a contract not only between the state and the corporation, but between the corporation and stockholders, and between the several classes of stockholders."

In the article on the Undistributed Profits Tax in XII Indiana Law Journal 19, at p. 28, apropos of the identical section of the income tax law involved here, it is said:

> "That the charter of a corporation is a contract was determined long ago in the famous *Dartmouth*

College case, and the charter in the case of the Indiana corporation contains provisions which 'expressly deal with the payment of dividends.' This would seem sufficient compliance with the requirements of Subsection 26 (c) (1) of the Act to entitle the corporation to credit when it is prevented from paying dividends by the terms of its charter."

In the article in 36 Columbia Law Review, p. 1343, it is said:

> "The Treasury has excluded corporate charters from the category of contracts thereby repudiating the traditional definition of a charter as a contract between the state and corporations."*

Every written contract is necessarily an express contract. North Dakota statute defines an express contract as one the terms of which are stated in words. In the case at bar the provision upon which we rely is in written words. If petitioner did not make the contract who did? Without at least two parties to it a contract cannot exist.

Every bank loaning money to a corporation with an impairment of capital stock does so in reliance on the corporation observing its contract with the State and not declaring dividends while this impairment exists. It would be superfluous for the bank to exact another contract to that effect.

Point IV.

The Charter Is a Contract "Executed" by the Corporation.

Petitioner was denied the credit in this case because Regulations 94, Article 26-2 promulgated under the Revenue Act of 1936, provided:

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*In fairness to the Treasury it is submitted the regulation was not intended to deny that a corporate charter was a written contract containing the State law but only to rule that it was not "executed" by the corporation and hence did not comply with the Revenue Act.

"The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of 26 (c) (2)."

We understand that it is not the intention of the Department by this Regulation to deny that the charter of a corporation is a written contract containing the law of the state expressly prohibiting the payment of dividends where a deficit existed (which it seems no one would deny in view of the foregoing authorities) but only to deny the credit because the Department takes the view that the charter contract is not "executed" by the corporation.

This regulation of the department has not been approved by the re-enactment of the statute and has very little effect because it has not been a long-continued regulation. *Iselin* v. *United States,* 270 U. S. 245, 250, 251; *Burnet* v. *Chicago Portrait Co.,* 285 U. S. 1, 16-21. Furthermore it is clearly an invalid regulation because it attempts to amend the law. *Manhattan General Equipment Co.* v. *Commissioner,* 297 U. S. 129, 134. Also while the Courts give great weight to administrative regulations the above regulation is not an administrative regulation but a regulation which seeks to interpret the law. As said in *United States* v. *American Trucking Assn.,* 310 U. S. ....., "the interpretation of the meaning of statutes as applied to justiciable controversies is exclusively a judicial function." The sharp distinction between the difference in weight given by the Courts to administrative regulations and interpretative regulations is pointed out in the excellent article in 52 Harvard Law Review 1163.* While it is the function of the executive department to administer the law it is the function of the Courts to interpret the law and this function

*In 40 Columbia Law Review 252 it is said the decision of this Court in the **Wilshire Oil Co. case** is "a striking example of the prevailing confusion." With regulations pouring out not only from all branches of the federal government but from forty-eight states it is imperative to clarify the rules as to their force and effect.

delegated to the Courts by the people in the constitution can not by the Courts be redelegated to the Executive Department. Nor can Congress confer it on the Executive Department. Furthermore the established rule in the interpretation of tax statutes is that all doubts must be resolved in the taxpayer's favor. The Treasury on the other hand is obliged when it drafts its regulations to apply the converse rule and resolve all doubts in the Government's favor because if it resolves the doubt in favor of the taxpayer the matter is at an end and the Courts will not be called upon to interpret the law. The Government is foreclosed. To permit a Treasury regulation made under the compulsion of resolving doubtful questions in the Government's favor to have much force is to substitute for the rule that all doubts and ambiguities must be resolved in favor of the taxpayer, the rule that doubts must be resolved in favor of a Treasury regulation, which as above pointed out must necessarily resolve doubts against taxpayers. It means nothing less than the abrogation of the time hoary rule and its replacement by the converse rule.

In 85 University of Pennsylvania Law Review at page 89, it is said with reference to the Section involved in this case:

> "Although these sections were made a part of the Act for the purpose of ameliorating possible hardship the Treasury Regulations bearing on the subject have practically destroyed all equity contained therein. * * * However, without entering into a technical discussion whether a charter of a corporation constitutes a contract in the orthodox sense, or constitutionally under the *Dartmouth College Case*, nevertheless it does appear that a corporate charter is within the spirit of the Section. It is probable that this regulation will not be upheld."

What then is the meaning of the word "executed" as used in the statute? Perhaps no word in legal phraseology has more varied meanings (Words & Phrases, Perm. Ed., Vol. 15, p. 555) which illustrates the legal axiom expressed

in the following classical language in *Towne* v. *Eisner*, 245 U. S. 418, at p. 425:

> "A word is not a crystal, transparent and unchanged; it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used."

The rule for the interpretation of this word is thus expressed in *Helvering* v. *New York Trust Co.*, 292 U. S. 455, 464. In interpreting the word this Court reiterated that it:

> "Will not look merely to a particular clause in which general words may be used, but will take in connection with it the whole statute and the objects and policy of the law, as indicated by its various provisions, and give it such a construction as will carry into execution the will of the legislature."

It is submitted that the object and policy of the statute as well as its legislative history supports our contention that the word "executed" was used by Congress in the statute to mean "binding on." No reason can be suggested for Congress intending it to have any other meaning.

The legislative history of the Act conclusively shows that Congress attached no special importance to the word "executed." The Ways and Means Committee referred to a "written contract **in existence** prior to March 3, 1936." (See Ways and Means Committee Report 2475, 74th Cong. 2d Sess., p. 8). (Boldface ours.) The Senate Finance Committee referred to contracts "**entered into** prior to March 3, 1936." (Finance Committee Report No. 2156, 74th Congress, 2nd Sess. p. 12) (Boldface ours).

What reason would Congress have had in mind for requiring the corporation to sign the contract? If it had intended this it would have used the word "signed." Plainly what it was aiming at and its object and policy was to relieve the hardship which existed in cases where

a corporation was forbidden to distribute dividends, albeit it desired to do so. Witness the section relieving banks and insurance companies and the reason for it stated in Congress (see page 38 hereof). The word should be construed in the light of the situation Congress was trying to relieve. No reason supports its narrow construction. In *Fletcher* v. *Peck*, 6 Cranch 87, 137, it was held a grant was an executed contract. A charter is a grant of a franchise. Being a grant it is an executed contract. *Farrington* v. *Tennessee*, 95 U. S. 679, 683.

The word "executed" is often used to indicate completion of a legal document in such form that it becomes legally effective and binding. For example a will is not executed when the testator signs it but only when the requisite witnesses also sign. When one party has performed a contract it is said to be "executed." In the Law of Contracts an oral contract may be executed as well as a written one. Nor need the writing which executes a written contract be in the same paper as the terms of the contract itself, as a multitude of decisions applying the Statute of Frauds hold. Sometimes a signed check completes the execution of a written contract. After a corporation accepts and operates under its charter it signs and files the corporate reports required by the state law, which law is part of its charter contract, and it signs checks for franchise tax. Otherwise state law would forfeit its existence. If it amends its Articles of Incorporation it signs the amendment under its seal.*

When a corporation acts under a charter it executes the contract. *Cf. Pearsall v. Great Northern Ry. Co.*, 161

*An example of a "written contract" signed by one party only is an insurance policy. A deed is another. **Kittelson v. Collette**, 61 N. D. 768. In **Nat. Bank v. Moody**, 90 S. W. (2d) 279, 282, it is said a written telegram or other writing signed by one party constitutes a written contract if accepted by the other.

U. S. 646, 677. Thus it has been held a charter must be accepted by the corporation before it becomes binding on the state. *People* v. *Hoffman*, 116 Ill. at page 629. And a grant of a charter to a corporation which has neither officers or stockholders is not binding because there is no one competent to contract. *Aspen Co.* v. *Aspen*, 5 Colo. App. 17; 37 Pac. 730. In these two cases the contract was not executed by the corporations. But when a corporation accepts a charter it cannot surrender it without the consent of the other contracting party—the state. *Mechanics Bank* v. *Heard*, 37 Ga. 411. It is submitted the statement of the Court below that the corporation did not make the charter contract flies in the face of all authority. If there was a contract the corporation necessarily made it.

That Congress did not use the word "executed" to mean signed is evidenced by the fact that it could easily have said "signed" but did not do so. It should not be held to have meant what it did not say. For example if a bank accepted a written statement of the corporation that it would not pay dividends and made a loan in reliance thereon, this would be a contract executed by both parties, although the bank did not sign anything. Surely if Congress meant to say "signed" it would not have said "executed" instead. That it did not say "signed" shows it did not intend to exclude charter contracts.

The legislative history above set forth indicates that Congress used the word "executed" in the sense of a contract accepted by the corporation or binding on the corporation or a contract made by the corporation or to which the corporation was a party. Pertinent here are the rules for construction of the law quoted on page 41 hereof. The Court below took the view that the charter was not a contract "made" by the corporation. It did not discuss the meaning of the word "executed." On the other hand

the Circuit Court of Appeals for the Ninth Circuit gave careful consideration to the meaning of the word executed and discussed it at length and in 110 F. (2d) at the bottom of page 289 and the top of page 290, concluded that the charter was a contract executed by the corporation within the meaning of the law.* In *Pennsylvania College cases*, 13 Wall. 190, this Court at page 212 said a corporate charter was an executed contract.

The 1939 Cumulative Supplement to the Law of Federal Taxation, Paul & Mertens, contains an extended discussion of this subject in Section 32A.43, beginning at page 1455. The authors cite many authorities for the following statements at page 1458:

> "Are charters contracts 'executed by' the corporation? Congress seems to have given little special thought to its use of the word 'executed.' The Ways and Means Committee refers to a 'written' contract *in existence* prior to March 3, 1936 (this date being extended to May 1, 1936.' Later the Senate Finance Committee refers to contracts '*entered into* prior to March 3, 1936 (date extended as above stated.)' If the word 'executed' is to be given the meaning attributed to that word by previous decisions of the courts it should probably be held to require only such acts as are necessary to bind the corporation by the written contract in question. Precise formalities should be unimportant if there is a binding obligation. A broad meaning should be given to the word 'execute' which properly ignores technicalities."

By the theory of novation the corporation made the contract when it accepted the charter and operated and filed the reports required by law and paid franchise taxes under it. It then became bound by the provisions of the

*Supporting this view see also Montgomery Income Tax Procedure for 1937, pages 726, 727. See also C. C. H. 1936 Tax Service, paragraph 5279.

charter contract. Compare *Harrison* v. *Barker Annuity Fund*, 90 F. (2d) 286. The charter contract was then executed by it within the meaning of the statute. All doubts as to the meaning of "executed" are removed when the purpose and spirit of the law is considered.

But whatever attenuated technical arguments may be made by respondent that the charter itself is not a contract "executed" by the corporation it can not be denied that the stock certificate of every corporation is a contract executed by it under its seal.

Point V.

The Stock Certificate Is a Contract Executed by the Corporation. It Contains a Provision Expressly Dealing With the Payment of Dividends.

That the stock certificate of the petitioner corporation which is signed by it under its seal constitutes a written contract can hardly be disputed.

In re Culbertson's, 54 F. (2d) 753, 757 (C. C. A. 9); *Jones* v. *Mo. Edison Elec. Co.*, 144 Fed. 765, 770; *Continental Ins. Co.* v. *Minneapolis R. Co.*, 290 Fed. 87; *Yoakam* v. *Providence Biltmore Hotel Co.*, 34 F. (2d) 533, 541; 36 Columbia Law Review, p. 1343; *Geiger* v. *Seeding Machine Co.*, 124 Ohio State, 223 at page 237; *Dagg* v. *Hammons*, 34 Ariz. 445; *Clearwater* v. *Meredith*, 1 Wall 25, 40.

(*a*) The legislative history shows Congress intended a stock certificate to be embraced within the unqualified statutory term "written contract." (*b*) The treasury has consistently and correctly recognized in the rulings hereinafter cited that a stock certificate is a contract within the meaning of the clause of the statute involved in this case. (*c*) Also in the income tax case of *Helvering* v.

Salvage, 297 U. S. 106, 109, this Court recognized a provision in a stock certificate fixing the price at which a stockholder might sell to a corporation was a binding contract. In *Clearwater* v. *Meredith*, 1 Wall 25, this Court said: "When any person takes stock in a railroad corporation he has entered into a contract with the company." (*d*) Impartial academic commentators agree with unanimity that a corporate stock certificate satisfies the terms of the statute.

Subpoint A.

The Legislative History Shows Congress Intended Stock Certificates to Be Embraced Within the Words "Written Contract" as Used in the Statute.

The legislative history conclusively refutes the contention that Congress intended the phrase "written contract" to refer to only ordinary everyday contracts. The following colloquy took place between Mr. Vinson who was in charge of the bill and another member of Congress (80 Congressional Record, part 6, p. 6230):

> "Mr. Hollister: 'I am not discussing the debt situation. Let us assume this condition comes into effect with respect to a preferred stock issue * * *. Let us suppose in the preferred stock issue it is provided that in the event dividends are declared of more than a certain amount then certain voting rights will come into effect or certain things will have to happen. Has that been covered in any way?'
>
> Mr. Vinson of Kentucky: 'It seems to me that certainly comes under paragraph 14, the contract provision.'
>
> Mr. Hollister: 'That is not a contract.'
>
> Mr. Vinson: 'Certainly it is a contract.' "

By such representations those in charge of the bill procured its enactment. It is submitted Mr. Vinson, now Judge Vinson, was clearly right.

In construing the statute recourse may be had to the statement of the member in charge of the bill. *United States* v. *Great Northern Railway Co.*, 287 U. S. 144, 154, 155.

Subpoint B.

The Treasury Rulings Recognize That a Stock Certificate Is a Contract Within the Meaning of This Provision of the Statute.

The Treasury rulings have consistently recognized that a stock certificate is a contract within the meaning of the statute. Where provisions are set forth verbatim in the stock certificate restricting the payment of dividends it has held a contract within the provision of the law involved herein exists and the taxpayers are entitled to the credit. I. T. 3152, C. B. 1938-1, p. 155. This ruling cites other rulings such as I. T. 3139, C. B. 1937-2, p. 111.

So far as we can discover the argument has never been advanced to the Treasury Department that the provisions of the State law are incorporated in the stock certificate as fully as if they were actually copied therein under the rule stated by this Court in the quotation at page 17 hereof and it has never considered and rejected this argument. There is no Treasury ruling on the point.

There is no distinction between a case where these statutory provisions restricting dividends are printed in a stock certificate and where they are not printed therein. They are as completely and fully a part of it in one case as in the other. (See authorities quoted on page 17 hereof.) It would be a superfluous and meaningless act to print the provisions of a state law in a stock certificate. The lawyer would be extravagant who would have it done. The restriction in the State statute on the corporation's

right to declare dividends is exactly the same whether it is printed verbatim in the stock certificate or read into it by the rule of law stated in the quotation from this Court on page 14 hereof. "In the field of taxation administrators of the laws, and the courts, are concerned with substance and reality." Mr. Justice Black speaking for this Court in *Helvering* v. *Lazarus*, 308 U. S. 252, 255. No reason can be suggested why Congress could have intended any such meaningless distinction and one so devoid of reasonable basis as that which the respondent would have this Court make. There would be as much reason for granting relief in one case as in the other and no reason why it should be granted in one case and denied in the other can be suggested. The policy and spirit of the law with equal force dictates relief in both cases.

The phrase of the revenue law here involved only requires the provision of the contract to be one "which expressly deals with the payment of dividends." The law does not say that the provision expressly dealing with the payment of dividends must be expressly stated in the contract itself and certainly the above quoted phrase of the law cannot be made to say this without twisting its words and ignoring the rules for the construction of tax statutes long established and repeatedly reiterated by this Court, all other Courts and text-writers, and stated at page 42 hereof. As the Court of Appeals for the Ninth Circuit observed in refusing to follow the ruling of the Court below it "confuses the wording of the statute" on this question. See 110 F. (2d) at page 289.

AUTHORITIES IN SUPPORT OF POINT V, SUBPOINTS C AND D.

The Stock Certificate Is a Contract Complying With the Words of the Statute Allowing the Credit.

In *Geiger* v. *Seeding Machine Co.*, 124 Ohio State 223, it is said at page 237:

> "This court has never been called upon to directly declare that a stock certificate is a contract between the holder and the corporation but several cases have been determined in which that principle has been necessarily assumed. It has many times been declared by courts in other jurisdictions (citing cases). It is not necessary to multiply authority on this point. It is a self evident principle."

In 36 Columbia Law Review, page 1343, where the provision of the law here involved and the regulation is discussed, it is said that the stock certificate satisfies the provisions of the law with reference to a written contract executed by the corporation even if the charter does not. The statement is as follows:

> "But even if it be assumed that there can be no contract with a non-existent entity, an objection which may be met by the theory of novation, the stock certificate which incorporates the terms of the charter, may realistically be viewed as a contract between corporation and shareholder, and therefore within the contemplation of the unqualified statutory term 'contract'."

In the article on the Undistributed Profits Tax in 26 Yale Law Journal at page 26 it is said:

> "It is true that the promotors and not the corporation, 'execute' the charter, but the corporation itself executes the stock certificates. The fact that there is

a written contract executed by the corporation should, moreover be even more clear when the certificates make reference to such restrictive charter provisions. There is no substantial difference between such cases and one where the corporation has executed a separate contract containing the prohibitions."

In the article on the Undistributed Profits Tax in 50 Harvard Law Review 332, it is said at the top of page 341:

"Where the restriction is contained in an amendment to the charter, however, the difficulty that the contract is not executed by the corporation seems absent. Hence the prohibition should be available as the basis of a credit. Furthermore where the restriction is repeated or expressly incorporated by reference in the stock certificate, it may be argued that such charter provision is part of the contract executed by the corporation with its shareholders. Nor should the result differ where there is no express reference to the charter in the certificate but the stock has been purchased in reliance on the restriction."

The Court will take judicial notice that the ordinary purchaser of stock buys it on reliance on the corporation's observance of the provisions of the state law enacted for the shareholders' protection. Substance is controlling in tax cases as this Court, speaking through Mr. Justice Black, said in the quotation at page 30 hereof.

The Provision of the State Law Restricting the Payment of Dividends Is as Fully a Part of the Stock Certificate Contract as if it Were Recopied Therein.

The assertion made in this headline follows from the principle of law often expressed by this and all other Courts and quoted from this Court on page 17 hereof.

In *Thompson* v. *Leggett,* 54 F. (2d) 753 (C. C. A. 9), Judge Wilbur, speaking for the Court, said at page 757:

> "This statutory condition imposed upon the right or privilege of calling in or redeeming preferred stock, although not expressed in the retirement provisions of any of the certificates here involved, is, upon familiar legal principle, to be read into those provisions." (Citing authorities.)

In *Geo. H. Hammond Co.* v. *Hastings,* 134 U. S. 401, this Court said:

> "It was unnecessary to enter upon the certificate any statement of the limitatitons and burdens which the law casts upon all such paper."

In *Jones* v. *Mo. Edison Electric Co.,* 144 Fed. 765, 770 (C. C. A. 8), the Court said:

> "The relationship existing between a corporation and its stockholders is one of contract * * * in which the charter and by-laws of the corporation *and pertinent statutes of the state are embodied.*"

In *Yoakam* v. *Providence Biltmore Hotel Co.,* 34 F. (2d) 533, 541, the Court said:

> "Where possible, we must endeavor to give effect to all provisions of the statute and certificate which are sufficiently clear and definite as to be reasonably understood and expressive of the agreement between the incorporator and between the corporation and its stockholders. *Such provisions are a constituent part of the contract entered into.*"

If, as this Court has many times said, substance and not form is controlling in taxation and "taxation is eminently practical" how can it now say that if the provisions of a state law prohibiting dividends are copied in a stock cer-

tificate the taxpayer has relief but otherwise it must pay although its situation in substance is identical in both cases? That to so construe the statute renders it unconstitutional, see page 44 hereof.

Subpoint C.

The Legislative History Supports the Construction of the Law for Which Petitioner Contends Because it Shows the Proponents of the Law Stated Corporations Forbidden By Law to Declare Dividends Were Granted Relief.

As previously pointed out the Board of Tax Appeals decided this case against petitioner entirely on the basis of legislative history. This Board opinion primarily influenced the Court of Appeals for the Second Circuit to reach the same conclusion in *Bastian Bros.* v. *McGowan,* 113 F. (2d) 489. In fairness to the Board it must be pointed out no argument based on legislative history was made to the Board for the taxpayer and it was deprived of the result of a research into such history from the taxpayer's standpoint. Such legislative history argument as it had before it was the *ex parte,* colored, biased argument of respondent (see R. 31-33). As a result of this, important legislative history which we submit would have caused both the Board and the Second Circuit, and we hope will cause this Court, to reach a different conclusion was wholly overlooked.

In the first place the Board uses legislative history addressed to original House and Senate bills differing radically from the one which was enacted into the law now before the Court and which was drafted by the Conference Committee after the House and Senate had originally acted and the Board's attention was not called to vital legislative history of the Conference bill which was the one

that became the law now before this Court. The Board overlooked the history of the bill that became law and used the history of bills that did not become law. In the second place from such legislative history of the original Senate and House bills as it sets out in its opinion the Board made a clearly illogical deduction which is patent on the face of its reasoning.

The Board reasoned that because a bill which originally passed the House contained a provision granting relief to *all* deficit corporations and this was omitted from a bill that originally passed the Senate (the legislative history failing to show the reason for the omission) it conclusively followed from this alone that Congress did not intend by other and more limited provision to grant relief to a limited class of deficit corporations which might otherwise fall within this other and more limited provision and however it may read on its face this other provision must be construed to deny such relief. This does not follow because the debates in the Senate showed that there were only thirty-six states in which corporations with impairment of capital stock were prohibited from declaring dividends (see p. 23, Petition for Certiorari herein). There was no reason why deficit corporations of the remaining twelve states where this prohibition did not exist should be granted relief. The provision in the House bill, granting relief to *all* corporations whether prohibited by charter contract or not from declaring dividends, was too broad because it granted it to corporations of twelve states which did not need it and were in the same situation with respect to the right to declare dividends as surplus corporations. It was probably because of this that the Senate struck it from the bill. Most members of the Senate were lawyers and knew that corporations prohibited by charter contract from declaring dividends were pro-

hibited by contract from doing so. They were in a different situation than corporations which could declare dividends. It was logical for the Senate to consider they were taken care of by the contract provision. They needed relief while the others did not. Indeed the proponents of the bill in the Senate stated they were granted relief as hereinafter appears. There is no provision in the law which could grant them relief except the contract provision. The statement of the proponents of the bill that such corporations were granted relief is the vitally important legislative history overlooked by and not brought to the attention of the Board.

The dissenting Judge who upheld respondent's contention in the case of the *Northwest Steel Rolling Mills case* correctly stated in 110 F. (2d) 290 that the legislative history of the original bill that passed the House and of the original Senate bill "is not helpful." Thereby he rejected the basis of the Board's decision in this case. He called to attention the reason for this stated in Paul & Mertens Supplement to the Law of Income Tax as follows:

> "The House and Senate 1936 Bills were dissimilar in general aim, theory and in structure. The 1936 Act, as finally enacted, was to a considerable extent written in conference without any new statement of legislative intent—a fact which contributes in no small measure to the difficulty of interpretation of the Act."

There is, as above emphasized and here re-emphasized, very pertinent and vital legislative history pertaining to the Conference bill which has heretofore been completely ignored and wholly overlooked. The bill which became law was the one written in conference. The legislative history surrounding this bill shows that its proponents

in the Senate assured those who opposed it that it granted relief to corporations forbidden by law to declare dividends. The Senate Minority Report on the Conference bill, June 19, 1936 (80 Con. Rec. Part 10, page 10164), signed by Senator Walsh and George, states as follows:

> "The defenders of the bill in the form which it has now taken contend that by sundry exemptions and modifications the smallest corporations are spared the full force of the new tax as well as helped by the lowering of the rates on the normal income tax; that the banks and insurance companies are entirely excluded; and that in some instances corporations under contract not to pay dividends, *and forbidden by law to do so, are permitted without extra penalties* to apply a percentage of their earnings to reserve." (Italics ours.)*

This is quoted from a Conference Report on the very statute which is before the Court and which that Conference Committee drafted and is competent and material. No proponent of the bill denied it was true. From it there can be no question that the proponents of the bill thought corporations forbidden by law to declare dividends were granted relief and gave such assurance to other Senators in order to procure their votes for the bill.

That Congress did not intend to impose the undistributed profits surtax on profits which a corporation was not allowed by law to distribute, even in cases where it had a large surplus, is indicated by the following colloquy (80 Con. Rec., Part 10, page 10265):

> "Mr. Rich: 'What is the difference between an insurance company and a banking corporation and any other corporation so far as trying to save money

*Explaining the original House Bill on behalf of the Ways and Means Committee, Mr. Vinson said (80 C. R. Part 6, page 6212): "It should be stated that in Sections 14 and 15 recognition is taken of State laws, written contracts and the general principles dealing with nontaxation of return of capital."

> for a rainy day is concerned? Why do you exempt banks and insurance companies? If it is good for them why is it not good for any other corporation?'
>
> "Mr. Samuel B. Hill: 'They are compelled by law to keep certain reserves on hand'."

The proponents of the bill stated the same relief was granted other corporations forbidden by law to declare dividends and the same reason and policy dictated that it be granted. Hence the construction we ask harmonizes with the policy of the law.

In view of this it is impossible to say that the legislative history does not support the construction for which petitioner contends. It cannot be used to support a contrary construction without being misunderstood. The subsequent statement of an opponent of the bill (Senator Walsh) denying the construction of the law which he said its proponents placed on it was the correct construction (made in an attempt to defeat the bill) does not serve in the least to detract from the above showing of what the law's proponents (those who drafted it) had in mind.

Point VI.

The Spirit and Purpose of the Undistributed Profits Surtax Law Supports the Construction for Which We Contend.

The purpose, intent and underlying spirit of the law was to prevent rich men avoiding taxes by accumulating large earnings in corporations which they controlled. (See President's Message in House Report No. 2475, 74th Cong. 2nd Sess.) See also examination of witnesses by Senator Black, Senate Hearings, pages 265 to 268. *Sanford* v. *Commissioner*, 106 F. (2d) 882, 884; *Maryland Land & T. Co.*, 40 B. T. A. 1066, 1067.

The President's Message of March 3, 1936, stated as follows:

"The accumulation of surplus in corporations controlled by taxpayers with large incomes is encouraged by the present freedom of undistributed corporate income from surtaxes. Since stockholders are the beneficial owners of both distributed and undistributed corporate income, the aim, as a matter of fundamental equity should be to seek equality of tax burden on all corporate income whether distributed or withheld from the beneficial owners. As the law now stands our corporate taxes dip too deeply into the shares of corporate earnings going to stockholders who need the disbursement of dividends, while the shares of stockholders who can afford to leave earnings undistributed escape current surtaxes altogether."

See also speech of Senator Black, 80 Cong. Rec., pages 8813 and 8814. Senator LaFollette, page 9048.

The Report of the Senate Finance Committee (Report No. 2156, June 1, 1936) stated:

"Your Committee takes the view that the evil sought to be remedied, towit, the retention of profits by corporations to protect investors having large incomes against paying on larger incomes may be soundly corrected without doing the injustices above described."

Certainly the construction for which we contend will allow the law to correct the mischief aimed at and not do injustice.

Stockholders of a corporation, the capital of which was impaired, would not be taxable on distribution made out of capital. *Hadden* v. *Commissioner,* 49 F. (2d) 709 (C. C. A. 2). *Kinnear* v. *Commissioner,* 36 B. T. A. 153. Such stockholders upon return of their capital would always have a loss deductible from other income and which would serve to reduce their taxes otherwise payable on this other income. The purpose of the law was to force taxable divi-

dends into the hands of stockholders to get more tax. A return of capital cannot be and is not made taxable income by statute. It could never increase but would usually decrease a stockholder's taxes.

In the recent case of *United States* v. *American Trucking Associations*, 310 U. S. ....., this Court after observing that when the plain meaning of a statute produced absurd results the Court had refused to follow it, added:

> "Frequently, however, even when the plain meaning did not produce absurd results but merely an unreasonable one plainly at variance with the policy of the legislation as a whole, this court has followed the purpose rather than the literal words."

It is submitted that in the case at bar both the words of the statute and the purpose harmonize with the construction for which we contend.

Also it would have been out of harmony with the spirit and purpose of the law to permit rich and prosperous corporations to avoid this special surtax by electing to distribute income and to take that privilege away from deficit corporations forbidden by law to distribute income and penalize them for being unfortunate and unsuccessful. The President and other proponents of the law stated it was intended to aid small business.

To impose a heavier tax on a corporation with impaired capital stock than on a rich corporation with a surplus would be to ruin the corporation in failing circumstances and promote the prosperous one. We say Congress had no such intent. Yet, under the construction of the Court below, that is what the law does. This construction is at variance with the underlying purpose, spirit and intent of the Act which the opinion of the Court below wholly ignores and is untenable tested from any angle. The Court below failed to read the words of the law against the background of its spirit and purpose.

Point VII.

The Rules of Statutory Construction Applicable Here Make for a Construction in Accord With Petitioner's Contention. Clearly the Court Below Applied the Wrong Rule.

The Court below said of the provision of the law here involved (R. 43):

> "Such provisions in tax laws are to be strictly construed."

Its opinion is an example of the wholehearted application of this thought.

Petitioner replies that even if the provision were strictly construed, nevertheless it is squarely within its words and is entitled to relief; but petitioner submits the Court below failed to apply the proper rule of construction because the provision was referred to in all the Committee reports as a relief provision.

The Senate Committee on Finance said (S. Rep. No. 2156, 74th Cong. 2d Sess., p. 15):

> "Contracts not to pay dividends: This credit is in principle similar to a relief provision allowed in the House bill for the purpose of the undistributed profits tax imposed by that bill."

The House Report also referred to it as a relief provision (H. Rep. No. 2475, 74th Cong. 2d Sess., p. 9), saying:

> "A corporation, however, can not use more than one of the relief provisions which is cited but must use the one that will result in the smallest tax."

It has always been the rule in tax cases, applied by this Court, lower Courts and the Tax Board, that a relief provision is to be liberally construed to afford the relief it was intended to provide. *Old Colony Trust Co.* v. *Commis-*

sioner, 301 U. S. 379, 383. *Bonwit Teller & Co.* v. *United States,* 283 U. S. 258, 263. In *Kelly Springfield Tire Co.* v. *United States,* 81 F. (2d) 533, 535 (C. C. A. 3), the Court quotes with approval the following statement of the United States Court of Claims:

> "When a privilege or concession is granted, as in this statute, it is the duty of the court to give the largest and broadest construction in favor of the concession, which the language used will allow in order to afford the relief which the context indicates was intended."

The rule that relief provisions are to be construed liberally has been uniformly applied in tax cases. *Johnson,* 33 B. T. A. 551, 553; *Standifer Construction Co.,* 4 B. T. A. 525, 561.

In the article on the Undistributed Profits Tax in 26 Yale Law Journal at page 25, it is said:

> "It would seem that since the section under consideration was designed to ameliorate a high tax rate, it should be liberally construed in favor of the taxpayer. The Treasury regulations however give it a strict and narrow construction."

See also quotation at page 22 hereof from U. of P. Law Review.

Moreover the relief provision was enacted in a spirit of fairness and was founded on reasons of public policy in order not to offer an inducement to corporations to violate State civil and criminal law prohibiting distribution of dividends except from surplus and in order to keep tottering corporations in business and to prevent discrimination in favor of rich ones. Destruction of small corporations will create monopoly. Even if the law should be considered an exemption it is settled that an exemption granted from motives of public policy is not to be construed strictly but on the contrary is to be construed liber-

ally. *Helvering* v. *Bliss,* 293 U. S. 144, 151; *Cochran* v. *Commissioner,* 78 F. (2d) 176, 179 (C. C. A. 4); *Roches Beach, Inc.* v. *Commissioner,* 96 F. (2d) 776, 779 (C. C. A. 2); *Faulkner* v. *Commissioner,* 112 F. (2d) 987, 991 (C. C. A. 1).

There is another rule of statutory construction applicable here and that is that doubts and ambiguities in a taxing statute are to be resolved in favor of the taxpayer and against the Government. This rule has been many times reiterated by this Court. *Hassett* v. *Welch,* 303 U. S. 303, 314; *Crooks* v. *Harrelson,* 282 U. S. 55, 61. The conflict between the Circuit Courts of Appeal alone (ignoring the above quotations from the law reviews of our leading universities) indicates that the law is doubtful. If so, the doubt must be resolved in the taxpayer's favor. The oft applied rule that Statutes in favor of those on whom taxes are assessed are remedial and are to be so liberally construed that the letter of them may be extended to embrace cases within the mischief intended to be prevented, is stated in Lewis & Sutherland on Statutory Construction, Vol. 2, Sec. 680, p. 1075.

The above rules the learned Court below wholly ignored and used opposite rules to reach its decision.

Point VIII.

If Construed as Urged By Respondent the Statute Violates the Fifth Amendment.

If the taxpayer had recopied the provisions of the State law into its stock certificate it would be unquestionably granted relief. (See authorities cited on page 29 hereof.) However, it is in exactly the same situation with respect to the payment of dividends. Although it has not recopied the State law into its stock certificate that provision is recopied into the certificate by virtue of the rule stated by this Court and quoted on page 17 hereof

and applied by the Court of Appeals for the Ninth Circuit in *Northwest Steel Rolling Mills case.* See also *Geo. H. Hammond Co.* v. *Hastings,* 134 U. S. 401. If the statute be construed to grant relief in one of these cases and deny it in another then it makes an unreasonable, defenseless classification and fails to meet the definition of reasonable classification set forth by this Court in *Traux* v. *Corrigan,* 257 U. S. 312, at page 337. It is so arbitrary and capricious that it violates the Fifth Amendment. *Nichols* v. *Coolidge,* 274 U. S. 531; *Untermeyer* v. *Anderson,* 276 U. S. 440; *Heiner* v. *Donnan,* 285 U. S. 312; *Helvering* v. *City Bank,* 296 U. S. 85, 92; *Hoeper* v. *Tax Commission,* 284 U. S. 206.

Another constitutional objection is that an income tax on corporations is an excise (*Flint* v. *Stone Tracy Co.,* 220 U. S. 107), which the constitution requires to be uniform. This statute imposes a higher rate on undistributed than on other income. The tax does not operate with geographical uniformity throughout the United States because it gives deficit corporations incorporated under the laws of twelve states an election to avoid it and no election to those formed in other thirty-six states. This is an indefensible discrimination. The construction for which we contend says Congress did not intend to make it while that for which respondent contends holds it did. This Court has said a national law should be construed if possible to operate uniformly.

Also the failure to tax corporations which recopied the state law in the stock certificate and those which did not although both are in an identical situation, violates the uniformity guaranty. In *Miller* v. *Nut Margarine Co.,* 284 U. S. 489 at page 510, this Court said of failure to tax others identically situated:

> "Such discrimination conflicts with the principle underlying the constitutional provision directing that

excises laid by Congress shall be uniform throughout the United States."

Berman v. *Board of Education of City of Chicago,* 360 Ill. 535 at pages 542, 543 is a reiteration of the holding that under the constitutional due process clause "a law must be binding upon and affect alike each member of the community of the same class." *Cf. Hartford Insurance Co.* v. *Harrison,* 301 U. S. 459.

Also if the construction urged by the respondent should be adopted it would permit wealthy corporations to avoid the surtax by distributing a dividend and grant no election to avoid it to a poor and tottering corporation. It would open a relief door to the rich and none to the poor. One does not need it and the other does. It would penalize the poor one at the expense of the rich and this without any reasonable basis. It would tend to drive the poor ones out of business and concentrate business in the rich ones and create monopoly which is against the public policy of this country as evidenced by the Statutes against monopoly. Also it would be contrary to the declared purpose of the law's proponents, including the President, to aid small business.

Also if construed as respondent contends it should be, the statute makes a baseless distinction between charter contracts and all other contracts. As the Court of Appeals for the Ninth Circuit held in the *Northwest Steel Rolling Mills case* (110 F. (2d) at page 290) this one arbitrary distinction alone casts grave doubt on its constitutionality.*

*In its recent decision in Prudential Tobacco Co., 42 B. T. A. No. 80 upholding the constitutionality of this law the Board of Tax Appeals said: "While we are not entirely free from doubt upon the present question, nevertheless, we are unwilling to declare it unconstitutional upon the present record." In that case however, the above arguments were not made and it was only argued that the law was unconstitutional because it was retroactive until January 1, 1936; that where a corporation's fiscal year ended March 31, 1936 it had no notice of the law and no opportunity to declare dividends during the taxable year and avoid the tax. The 1936 act became law June 2, 1936.

It must be borne in mind that the undistributed profits tax is not an income tax laid on all income like all preceding income taxes the country has known but is a tax laid only on undistributed income. It may be avoided by distributing income. Its design was to force distribution of income in order to collect more taxes from stockholders and it is in substance a penalty for failure to distribute income. To say that Congress has power to impose an income tax on the income of a corporation even if it has a deficit is entirely different from saying that Congress has power to impose a tax according to the use to which income is put and condition an income tax upon a corporation's failure to unlawfully distribute its earnings in dividends. **Can Congress condition an income tax on the failure to do an unlawful act?** The income tax is a uniform income tax or excise levied for the support of the Government while this tax is designed to regulate the internal affairs of the corporation (see 46 Yale Journal at p. 48) by forcing it to pay out its earnings. The regulation of a corporation's internal affairs is a matter reserved by the Tenth Amendment to the States. *United States* v. *Butler,* 297 U. S. 1. It is for the State to declare its own public policy with respect to the declaration of dividends by corporations which it creates. *Hopkins Fed. S. & L. Asso.* v. *Cleary,* 296 U. S. 315, at page 337. See also 2 John Marshall Law Quarterly 340. Also the tax puts a higher rate on undistributed income dollar than put on the distributed income dollar.

The tax upheld in *Helvering* v. *National Grocery Co.,* 304 U. S. 282, was a tax on the failure to do a lawful act, whereas the tax in the case at bar is not imposed unless the corporation has failed to do an unlawful act—if the construction of the law upheld by the Court below be the correct one.

The construction urged by respondent says in effect: "If you do a criminal act you shall not be taxed, but if you fail to you shall be taxed." Would anyone doubt the unconstitutionality of a tax statute which provided for taxing trucks in interstate commerce at 1c per mile with a "credit" for all miles the driver drove on the left-hand side of the road at 70 miles per hour or more? But this is the effect of what respondent contends when he says corporations must pay unless their directors violate the civil and criminal laws of the states.*

It would also put a premium on the violation of the criminal law of most of the states and the civil law of 36 of them and hold out an inducement to violate not only state criminal law but state civil law. No federal statute should be so construed unless there is no escape from such a construction.

The Court is asked to read the article on the constitutionality of the law in XIV Tax Magazine 640.

As the Circuit Court of Appeals for the Ninth Circuit held, it is not necessary to so construe it. It is unnecessary to read the statute to say an income tax is by it conditioned on the failure to do an unlawful act. As said by Mr. Justice Holmes in *United States* v. *Jin Fuey Moy,* 241 U. S. 394, 401:

> "A statute must be construed, if fairly possible, so as to avoid not only the conclusion that it is unconstitutional, but also grave doubts upon that score. *United States ex rel. Atty Gen.* v. *Delaware & H. Co.,* 213 U. S. 366, 408, 63 L. Ed. 836, 849, 29 Sup. Ct. Rep. 527."

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*In most states it is a crime to declare a dividend out of capital. Thus see Section 664 of the New York Penal Law making it a misdemeanor to vote for a dividend except from surplus. That it is also a misdemeanor at common law in a case where the Civil Statutes impose a duty on directors not to declare a dividend except from surplus and the Criminal Law is silent see 14 Corpus Juris, Sec. 2073, page 244.

Finally, and wholly apart from the constitutional question, the construction asked by respondent produces such unfair results that it ought not to be made by this Court. Certainly it is not necessary to make it. "Taxation is an intensely practical matter, and laws in respect of it should be construed and applied with a view to avoiding so far as possible unjust and oppressive consequences." *Farmers L. & T. Co.* v. *Minnesota,* 280 U. S. 204, 212

CONCLUSION.

In conclusion it is respectfully submitted that the judgment below should be reversed.

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APPENDIX.

Statutes Involved.

(U. S. C. Supp. III, Title 26, Sec. 13a.)

Sec. 26. **Credits of Corporations.**

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * *

(c) *Contracts Restricting Payment of Dividends.*—

(1) *Prohibition on Payment of Dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

North Dakota Compiled Laws—Supplement—(Annotated), 1913-1925:

> "SEC. 4543. *Dividends only from profits; limitations of indebtedness; exceptions.*—The directors of corporations must not make dividends except from the surplus profits arising from the business thereof; nor must they divide, withdraw, or pay to the stockholders, or any of them, any part of the capital stock, * * *"

Treasury Regulations 94 (1936 Ed.), promulgated under the Revenue Act of 1936:

> "The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c)."

FILE COPY

IN THE

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OCTOBER TERM, 1940.

No. 8

CRANE-JOHNSON COMPANY, a corporation of North Dakota,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

REPLY BRIEF FOR PETITIONER.

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The Court will take judicial notice of such a matter of common knowledge as that a corporation issues stock certificates. In any event respondent's argument that the question whether a stock certificate is a contract was not properly raised below, cannot avail it on the general question before the Court because the decision in the *North-*

west Steel Rolling Mills case, argued herewith, was in favor of that taxpayer and that taxpayer is entitled to sustain that decision by any argument it can advance to show that decision was right and it does advance the argument that the stock certificate is a contract (Petitioner's Brief therein, p. 43). Indeed, respondent concedes on page 36 of his brief in the case at bar that the stock certificate is a contract. See also *Bedford* v. *Eastern Building & Loan Association,* 181 U. S. 241. He cannot deny that the North Dakota Corporation law which expressly deals with the payment of dividends is a provision of this stock certificate contract exactly as if recopied therein, (*Walker* v. *Whitehead,* 16 Wall. 314 and *Edwards* v. *Kearzey,* 96 U. S. 601). On page 18 of his brief he expressly concedes this.

This concession forces him, as a last resort, to the argument that the income tax statute here involved should be read as if it required "a provision expressly written into a contract and not one that is implied." Such are not the words of the statute. Certainly the plain words of the statute cannot be thus distorted and altered without ignoring all the applicable rules of statutory construction set forth in our main brief nor can the words of the statute be so distorted without ignoring entirely the intention of Congress and especially the situation which it sought to relieve by the relief provision now before the Court. No more need be said to entitle petitioner to prevail.

On page 6 of his brief respondent argues that the statute should be read as if it required "a provision expressly written into the contract and not one that is implied." At the bottom of page 19 and the top of page 20 of his brief respondent repeats this argument. The trouble with this argument is that the statute does not read the way

respondent would have it read. Also it wholly disregards the fact that the taxpayer is in the identical situation in both cases. We make the point that respondent's argument adds something to the words of the statute which are not there. The plain words of the statute are "a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends." Under these words it matters not whether the provision be express or implied. Why should it matter?

Congress did not make the statute read "a provision expressly written into the contract and not one that is implied," as respondent on pages 19 and 20 of his brief argues it should read, and the statute cannot be made to so read without amending it to change its wording. This is not within the judicial power.

It has long been settled that what is implied in the Constitution is as much a part of it as that which is expressed (*Yarborough,* 110 U. S. 658) and what is implied is as much a provision of a contract as what is expressed. Contracts, 12 American Jurisprudence, Sec. 239, p. 765; 17 C. J. S., Sec. 328, p. 778. This is equally true whether the contract be written or oral. It is elementary that the statutory law applicable to it is a part of every written contract. 12 American Jurisprudence, Sec. 240, p. 769; 17 C. J. S., Sec. 330, p. 782. The lawyers on the Conference Committee knew the charter included the state corporation law and constituted a written contract.

Respondent contends our premise that a corporate charter is a written "contract" is unrealistic solely because

he alleges in normal parlance the unqualified statutory term "contract" does not embrace a corporate charter. With that we take sharp and emphatic issue. This same rule of statutory construction which requires words to be taken in their natural and ordinary meaning in common speech is applicable also in the construction of the Constitution. *Pollock* v. *Farmers Loan & Trust Co.*, 158 U. S., 618. If the unqualified word "contract" when used in the Constitution embraces a corporate charter then there seems no escape from the conclusion it must also embrace a corporate charter when used in a statute—no contrary intent clearly appearing. Especially when it appears in a statute written by a Conference Committee composed of excellent lawyers to whom the then ancient and repeatedly and unanimously followed decision in the *Dartmouth College case* was an elementary part of common knowledge.

Judicial notice will be taken that nearly all members of the Congress enacting this law were lawyers and those not lawyers were familiar with the decision in the *Dartmouth College case* holding a corporate charter to be a contract. It is a rule of statutory construction that where a word used in a law has previously been construed by the Courts and has acquired a settled significance the word is presumed to have been used by Congress in that sense unless a contrary intent clearly and unquestionably appears. *Heald* v. *District of Columbia*, 254 U. S. 20, 23. No such intent appears here. Instead of such contrary intent appearing it cannot be denied by anyone that a corporate charter is embraced within the spirit of the statute. By the above rule of construction it is also embraced within its letter. To so hold is to carry out the just endeavor of Congress not to penalize cor-

porations for failing to do something that could not be done.

With reference to a statute being a contract, this Court said in *New Jersey* v. *Yard,* 95 U. S. 114:

> "The greatest trouble we have had on this point has been in regard to what may be called legislative contracts—contracts found in statute laws of the State, if they existed at all. It has become the established law of this court that a legislative enactment in the ordinary form of a statute, may contain provision which, when accepted as the basis of action by individuals or corporations, become contracts between them and the State within the protection of the clause referred to, of the Federal Constitution."

Respondent, ignoring the exact and accurate point involved here that the statute is a provision of the charter contract, tries to substitute the straw man general question of whether statutes are contracts and having set up his straw man argues to demolish him that if Congress "had this intention, it would have been a simple matter for it to have said so." We say that if Congress had any intention of excluding a corporate charter from the unqualified statutory term contract and of modifying the elementary principles of law and common knowledge on which we rely it would have been a simple matter to have said so and it would have said so. Not having excluded it and in view of the common understanding of all lawyers that a corporate charter is a contract the unqualified statutory term "contract" must be deemed to include a corporate charter. Congress must certainly be deemed to have known this elementary principle and legislated with knowledge of it.

At the bottom of page 21 of his brief and at page 45 thereof respondent argues that to hold a corporate char-

ter to be a contract would place "an intolerable burden" on the Bureau of Internal Revenue. This is an argument which we submit is without basis. How about the burden on almost bankrupt taxpayers who must pay if respondent is upheld? None of the debates in Congress lend any support to it, nor does any other part of the legislative history of the act show such an idea was even suggested. Respondent happened to think of it in his desperate groping for something to advance in argument.

As stated in Congress there are thirty-six states which prohibit deficit corporations declaring dividends. Certainly the other twelve give no trouble. At the bottom of page 50 of his brief respondent concedes the great weight of authority in these thirty-six states is that a corporation may not declare a dividend unless it has a surplus. The annual corporation income tax returns, the capital stock tax returns, as well as estate tax returns making essential the valuing of corporate stock—all of which are in the files of the Bureau, disclose whether a corporation has a surplus or a deficit. This is already known to the Internal Revenue Bureau. Each year its agents have audited corporations' books. There is no recorded tax decision where any difficulty has been encountered in determining whether a corporation's capital is impaired. The problem is no different than the problem of valuation for tax purposes which is inseparable from many other provisions of tax laws. As to the need to consult state law this cannot be avoided in tax cases. *Cf. Helvering* v. *Fuller,* 310 U. S. 69.

On page 23 of his brief respondent quotes this Court that the income tax statutes "in the absence of language evidencing a different purpose should be interpreted so as to give uniform application to a nation-wide scheme of

taxation." We invoke this point at pages 44 and 45 of our main brief and show how it supports our contention. What respondent here asks the Court to do is to so construe the statute that deficit corporations in twelve states have an election to avoid the tax while those existing in the other thirty-six states have no such election. This construction will not produce but will destroy uniformity for other reasons. (Also see pp. 44 and 45 of our main brief.) On the other hand the construction for which we contend will produce uniformity and not discriminate against the poor struggling corporation in favor of the rich one.

We also take sharp issue with the argument of respondent that Congress deliberately omitted a provision giving relief to deficit corporations in order to tax them. The legislative history shows a contrary intention. The House bill granted them all relief. This shows the House did not want to tax them. The Senate hearings at page 282, show that one Alvord testified it would be a hardship to impose a tax on deficit corporations. Senator Barkley asked him what remedy the Senate should adopt for that situation. Alvord suggested a flat rate of tax. The Senate adopted his suggestion in its bill which the Conference Committee later rejected and rewrote.

The Senate bill according to the statement of the Committee Report set forth on page 39 of our main brief desired to avoid "doing the injustices above described." At page 5 of this same Senate Committee Report one of the "injustices above described" was stated thus:

> "The plan penalizes small corporations and corporations with insufficient reserves and is of decided advantage to the large corporation and the corporation with excessive surplus."

Notwithstanding the Senate Committee stated it did not desire to do the above described injustice, nevertheless respondent would have this Court hold it did and argues that it omitted the provision of the House bill relieving all deficit corporations, because it intended to tax all of them.

Furthermore the legislative history set forth on page 33 of respondent's brief shows that as soon as the unwarranted administrative construction which we contest in this case was called to its attention Congress rebelled against and corrected it. This is inconsistent with respondent's contention that this administrative construction was in accord with what Congress previously "deliberately" intended. Instead of supporting respondent this action of Congress supports petitioner.

As shown on page 37 of our main brief the authors and proponents of the Conference bill stated corporations such as petitioner were not taxed by it.

On page 19 of his brief respondent claims that to construe the word "executed" to mean "made" renders the word superfluous. We are utterly unable to follow this reasoning. Under our contention the statute would read exactly the same whether Congress had used the word "executed" or the word "made." Nor can we follow the argument on page 21 adopted by the Court below that 26 (c) (2) deals with a situation at all similar to 26 (c) (1). The two situations are different except that in both cases the corporation is unable to pay the earnings in dividends. Section 26 (c) (2) shows Congress was trying to extend and make more comprehensive its relief.

It seems plain to us that the House Report, quoted on page 25 of respondent's brief, shows Section 15 was de-

signed to take care of corporations existing in the 36 states where deficit corporations were prohibited from paying dividends and that Section 14 was included to take care of the deficit corporations existing in the other 12 states where they were not so prohibited. These corporations, however, did not imperatively need this relief and that alone justified the omission of Section 14 from the Senate bill. They had an option to avoid the tax but deficit corporations in the other 36 states did not have this option.

It seems obvious to us that the change in the definition of a dividend by the Senate bill, stressed at the bottom of page 28 to page 30 of respondent's brief could only have related to corporations existing in the 12 states where they could legally declare dividends. To assert that it related to those of the other 36 states is to impute to Congress an intention that corporations in these 36 states might be induced to violate state law and would violate it.

Whether a return of capital can ever be made taxable income by law is at least a debatable question. Certainly if your Honor has invested $50,000 in a corporation which proceeds to lose $25,000 and you only recover $25,000 of your original investment, it would seem such $25,000 cannot be made a taxable dividend. If it is not a taxable dividend then there is no dividend paid credit by virtue of another provision of the law. *Centennnial Oil Co.* v. *Thomas,* 109 F. (2d) 359; cer. den. 310 U. S. .....

On page 30 respondent shows Senator Walsh did not think the contract provision relieved deficit corporations forbidden by law to declare dividends. We agree that Senator Walsh did not think so. Our point is that he stated the proponents of the bill thought so. His state-

ment cannot, as respondent asserts, be taken to allude to the general provisions of Section 14 (c) discussed at the bottom of page 31 of respondent's brief. This provision applied to all corporations and there is nothing to indicate that anyone had corporations forbidden by law to declare dividends in mind in connection with it. Certainly it is more persuasive from the standpoint of legislative history to show what the proponents and drafters of the bill thought it did than what its opponents thought. It is well known that opponents of a bill are likely to allege almost anything they think might help to defeat it.

On page 36 of respondent's brief and again in note 7 on page 28 the impression is given that petitioner herein raised the issue that the stock certificate was a contract for the first time in a petition for rehearing. Inasmuch as respondent states petitioner's reply brief has been filed with this Court we submit that a reading of pages 6 and 7 of that brief will show how clearly and squarely the issue was raised in the court below. It was also emphasized in oral argument in that court and in the petition for certiorari. However the issue is squarely before the Court in the companion *Northwest Steel Rolling Mills case*, argued herewith. Also when laymen are allowed to practice before an administrative board the old technicalities of the common law clustered about appeals ought to give way in appeals from that board.

With reference to the argument that petitioner made "no express agreement that its directors would not distribute dividends except in accordance with state law" we think it did but answer that the provision of the income tax law here involved does not require an express agreement but only a provision of a written contract (regardless whether express or implied) which provision ex-

pressly deals with the payment of dividends. Respondent seems to concede on page 37 of his brief that "such an agreement is implied by law." This being so his case fails. Not only the letter but the reason of the law dictates relief in both cases because an implied provision expressly dealing with the payment of dividends places a corporation in the same position as an express provision of a contract.

In his constitutional argument respondent seems to rely on *Helvering* v. *National Grocery Co.*, 304 U. S. 282. That case is not in point for two reasons. First the tax in that case was imposed because of failure to do a lawful act. Secondly, the tax there was plainly necessary to prevent evasion of the individual income tax. A tax on deficit corporations would not prevent such evasion. In this connection it is interesting to note that all the cases collected in note 4 on page 15 of respondent's brief are all cases of struggling corporations and each involves a few hundred dollars in income tax. These are typical of the overwhelming majority of deficit corporation cases.

At pages 47 to 54 of his brief respondent argues petitioner has not sustained the burden of proving it was prohibited by state law from distributing dividends. When reference was made to a "deficit" corporation in the legislative history of this provision of the law whether in the debates, in the Committee Reports or in the proposed bills it referred to only one thing—a corporation with an impairment of capital stock. It means that in accounting. The stipulation entered into between the attorney for the Government and the Certified Public Accountant who represented the petititoner before the Board of Tax Appeals states in plain terms (R. 12) that "as of January 1, 1936, the petititoner had a deficit of at least $21,251.40." The

Board found the fact as stipulated. If it had a deficit it did not have a surplus. If it had no surplus it could not declare a dividend under the North Dakota statute. The rule set forth at the top of page 50 of respondent's brief and there alleged to prevail in a few states and conceded by respondent at the bottom of page 50 not to prevail in the overwhelming majority of states is not the rule in North Dakota, as the quotation from the Supreme Court of that state together with the authorities cited by it set forth on page 15 of our main brief shows. These authorities which the Supreme Court of North Dakota cites are in accord with the majority rule.

The statement that the stipulation is based on the book figure, at the bottom of page 51 and at the top of page 52 of respondent's brief, is an inference instead of a flatly stipulated fact. However, even if it was based on the book figure the rule in tax cases is that the book figures are *prima facie* correct and stand as *prima facie* proof and in the absence of a contrary showing prevail.

All of which is respectfully submitted.

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No. 814

In the Supreme Court of the United States

OCTOBER TERM, 1939

CRAIG-JOHNSON COMPANY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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v.

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 14) is reported in 38 B. T. A. 1355. The opinion of the Circuit Court of Appeals (R. 41) is reported in 105 F. (2d) 740.

JURISDICTION

The judgment of the court below was entered August 8, 1939 (R. 45). A petition for rehearing was denied September 15, 1939 (R. 46). The petition for a writ of certiorari was filed December 12, 1939. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

The adjusted net income of the petitioner for the year 1936 was $12,032.72. As of January 1, 1936, the petitioner had a deficit of at least $21,251.40, the origin of the deficit not appearing. No distributions to stockholders were made during the year. A North Dakota statute prohibits the directors of a corporation from paying dividends except from surplus profits arising from the business. The questions presented are:

1. Whether the petitioner's charter or certificates of stock in conjunction with the North Dakota statute constitute a "written contract executed by the corporation" within the meaning of the credit provisions of Section 26 (c) (1) of the Revenue Act of 1936.

2. Whether Section 26 (c) (1), as construed by the court below, violates the Fifth Amendment.

3. Whether the petitioner has shown that it was prohibited by state law from paying out all or a part of its current earnings as dividends.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are set forth in the Appendix, *infra,* pp. 16–22.

STATEMENT

The facts were stipulated (R. 12–13) and found by the Board of Tax Appeals as follows (R. 14):

The petitioner was incorporated in 1903 under the laws of North Dakota (R. 12, 14).

As of January 1, 1936, the petitioner had a deficit of at least $21,251.40. The records prior to January 1, 1929, are not susceptible of analysis to show definitely

whether this deficit occurred from operating losses or capital distributions in excess of earnings or was effected by other adjustments. (R. 12, 14.)

No dividend distributions have been made by the petitioner since March, 1930, when $9,672 was so distributed from surplus balance existent at that time (R. 12).

The petitioner's net income for 1936 income tax computation purposes was $13,450.76. Its adjusted net income for 1936 was $12,032.72. (R. 13, 14.)

In its return for 1936, the petitioner claimed a credit under Section 26 (c) (1) of the Revenue Act of 1936 in the computation of the surtax on undistributed profits. The Commissioner disallowed this credit, determined a surtax of $1,707.36 on undistributed profits, and asserted a deficiency in that amount. (R. 12–13.)

The Board of Tax Appeals sustained the Commissioner's action in disallowing the credit in question and in determining the deficiency (R. 21–22), and the Circuit Court of Appeals affirmed (R. 45).

ARGUMENT

1. The provisions of Section 26 (c) of the Revenue Act of 1936, *infra*, pp. 17–18, the interpretation of which is here involved, appear in no other Revenue Act, earlier or later, and accordingly the question presented in this case can arise only for the taxable years 1936 and 1937. The question is therefore not of importance except as it bears upon the disposition of matters now pending in the courts, the Board of Tax Appeals and the Treasury Department. The Board and the court below are the only tribunals which have passed upon the question, and they are in accord in sustaining the Treasury's

construction of the statutory provision. While other circuit courts of appeals will undoubtedly rule upon the interpretation of Section 26 (c) hereafter, there would seem, in the absence of a present conflict, to be no impelling reason for this Court to review this case.[1] And, as shown *infra*, pp. 14–15, even if the petitioner's interpretation of the statute be accepted petitioner could not prevail in this case.

2. Section 14 (b) of the Revenue Act of 1936, *infra*, pp. 16–17, imposes a graduated surtax upon corporations computed on such portion of the undistributed net income as is in excess of certain percentages of the adjusted net income. The term "adjusted net income" is defined in Section 14 (a) (1) as the net income less certain credits, and the term "undistributed net income" is defined as the adjusted net income minus the sum of the dividends-paid credit provided in Section 27 and the credit provided in Section 26 (c), relating to contracts restricting dividends and debt payments.

---

[1] The question is now under advisement by the Circuit Court of Appeals for the Ninth Circuit in *Northwest Steel Rolling Mills* v. *Commissioner*, argued on December 5, 1939, on review from an unreported decision of the Board of Tax Appeals. The question is presented in two cases in the district courts, neither of which has yet been decided. *Bastian Bros. Co.* v. *McGowan*, Collector (W. D. N. Y.), motion to dismiss argued on December 11, 1939; and *Utah Hotel Co.* v. *Hinckley* (Utah). The Board has also decided the question in two other cases: *McBrides, Inc.* v. *Commissioner*, unreported memorandum opinion delivered June 20, 1939 (time for appeal has expired); and *Co-operative Publishing Co.* v. *Commissioner*, 40 B. T. A. 465 (time for appeal expires January 26, 1940).

Insufficient time has precluded inquiry of the Treasury Department as to the number of cases pending there.

Section 26 (c) (1) provides for the allowance of a credit to the extent of—

> An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. * * *

The petitioner contends that since its books showed a deficit of $21,251.40 and earnings for 1936 of only $13,450.76, it was prohibited by North Dakota statutes [2] from distributing any dividends during that year and that the statute constituted a part of its charter, which was a written contract with the state and with its stockholders. It argues, therefore, that under Section 26 (c) (1) there were no amounts which could be distributed within the taxable year as dividends without violating the provisions of a written contract executed by the corporation prior to May 1, 1936; and hence that it is entitled to a credit equal to the entire amount of its 1936 earnings.

We do not deny that for some purposes a charter of a corporation is said to be a contract with the state, or that the state corporation laws are for some purposes regarded as a part of that contract. See e. g., *Dartmouth College* v. *Woodward,* 4 Wheat. 518; *Home Bldg. & L. Assn.* v. *Blaisdell,* 290 U. S. 398. The question

[2] Section 4543 of the North Dakota statutes *infra*, pp. 19–20, prohibits the directors of a corporation from paying dividends "except from the surplus profits arising from the business thereof * * *." Section 4544, *infra*, p. 20, imposes civil liability on directors who violate this provision.

here, however, is whether the charter and the state laws together are a written contract executed by the corporation within the meaning of Section 26 (c) (1) of the Revenue Act of 1936.

Corporate charters are secured through the filing of articles of incorporation by individuals desiring to incorporate and the issuance of a certificate of incorporation by the state. The corporation itself has no existence until the certificate is issued and it obviously does not file the articles of incorporation. Hence the charter is not a written contract which the corporation itself has entered into and executed, even though it may subsequently be bound by its terms. And the statute here involved requires that there be a *written contract executed by the corporation.* The charter does not fulfill that condition.

In this case, moreover, the charter itself contained no provision restricting dividend payments. It is necessary to look to the statutes of North Dakota for the restriction. It seems obvious that a state law is not a written contract executed by the corporation, even though the corporation is bound by the statute and for that purpose it may be regarded as a part of its charter.

Practical considerations also indicate that Congress did not intend Section 26 (c) (1) to apply to charters and state statutes restricting the payment of dividends. Such statutes often differ widely in their wording, and different courts give diverse constructions to similarly worded provisions. The state courts differ, for example, in their treatment of appreciation, reserves for

replacements, depletion, accounts and loans receivable, and many other items.[3] If Section 26 (c) (1) is construed as referring to state laws restricting payment of dividends the Bureau of Internal Revenue will be required to determine in each case what the state law is, how it is administered in practice, and whether the particular corporation was so circumstanced that a payment of dividends by it would have violated the state law. This would impose an enormous burden upon the Bureau and one which Congress could scarcely have intended.

The legislative history of the undistributed profits tax provisions of the Revenue Act of 1936 supports the view that Congress did not intend to give special treatment to corporations which had deficits and were prohibited by state law from distributing dividends. The bill as introduced in the House contained three distinct provisions designed to relieve corporations which had a deficit or which for various reasons could not or should not pay dividends. Section 14 (a) provided that if the accumulated earnings and profits of the corporation as of the close of the taxable year (computed without dimunition by reason of the distribution during the taxable year of earnings and profits, or by reason of the taxes imposed by Title I of the Act) were less than the adjusted net income, the tax should be computed in a different manner. This provision was

[3] Many of the distinctions are pointed out in a series of articles entitled "Theory of Anglo-American Dividend Law," by Weiner, 28 Col. L. Rev. 1046, 29 Col. L. Rev. 461, and 30 Col. L. Rev. 330, 954. See also II Cook on *Corporations*, 8th ed., Sec. 546.

intended to relieve corporations having a deficit. Section 15 was designed for the relief of corporations having outstanding contracts not to pay dividends, and Section 16 was intended for the relief of corporations having an outstanding indebtedness (H. R. 12395, 74th Cong., 2d Sess., Secs. 14, 15, and 16).

The Committee on Finance of the Senate substituted for the graduated undistributed profits tax a flat surtax of 7 percent on undistributed profits. It also struck out Sections 14, 15, and 16 of the House bill, but in Section 26 (c) (1) retained the principle of Section 15 of that bill affording relief to corporations under contract not to pay dividends. An amendment to Section 26 (c) on the floor of the Senate restored the credit allowed to corporations under contract to pay indebtedness which had been contained in Section 16 of the House bill. See Section 26 (c) (2) of the Revenue Act of 1936, *infra,* pp. 17–18; 80 Cong. Rec., part 8, pp. 8790–8791, 9071. A graduated rate was also substituted for the flat surtax rate which the Senate Finance Committee had adopted. But no provision for the relief of deficit corporations analogous to Section 14 of the House bill was restored to the bill. See H. Conference Rep. No. 3068, 74th Cong., 2d Sess., pp. 2–4. See also Cong. Rec., *supra,* p. 9071.

By a change in the definition of a dividend in Section 115 (a) of the Revenue Act of 1934 (see Section 115 (a) of the Revenue Act of 1936, *infra,* pp. 18–19), the bill as passed allowed dividends-paid credit to deficit corporations which actually distributed current earnings (see Section 27 of the Revenue Act of 1936);

but none was allowed to deficit corporations which did not distribute.

Thus the failure of Congress to provide specifically for the allowance of a credit to corporations which had a deficit and were prevented by state law from paying out dividends appears to have been deliberate. Section 14 of the House bill would have given them relief but the bill as finally enacted did not do so. It appears, moreover, that the purpose of the Senate in making the change was to eliminate the necessity of determining when there was a deficit, for, in explaining Section 115 (a) the Committee on Finance said (S. Rep. No. 2156, 74th Cong., 2d Sess., p. 18):

> In order to enable corporations without regard to deficits existing at the beginning of the taxable year to obtain the benefit of the dividends paid credit for the purposes of the undistributed profits surtax, section 115 (a) changes the definition of a dividend so as to include distributions out of the earnings or profits of the current taxable year. The amendment simplifies the determination by providing that distributions during the year, not exceeding in amount the current earnings, are dividends constituting taxable income to the shareholder and a dividend paid credit to the corporation. As respects such dividends the complicated determination of accumulated earnings or profits is rendered unnecessary.

Attention is also called to the fact that Senator Walsh, a member of the Senate Finance Committee, stated on the floor of the Senate that the bill did not afford relief to corporations which were prevented by state law from declaring dividends except from earn-

ings. His statement was as follows (80 Cong. Rec., part 8, p. 9058):[4]

> Again, the laws of 36 States prohibit corporations chartered by them from making a dividend distribution if their capital is impaired. Under the proposed undistributed-profits tax, corporations affected by these provisions would be heavily penalized by the Federal tax for keeping within the law. The House bill taxes these corporations a flat rate on their net income of 22½ percent, regardless of their dividend policy.

The petitioner quotes (Pet. 23–24) an excerpt from the minority views of Senators George and Walsh (80 Cong. Rec., part 10, p. 10164), and suggests that apparently Senator Walsh, subsequent to the above statement on the floor of the Senate, had been told that he was wrong in thinking that no relief was afforded to corporations which were prevented by state law from declaring dividends except from earnings. That Senator Walsh had not changed his views, however, is clearly shown by the following statement made by him several paragraphs after the one quoted by the petitioner (80 Cong. Rec., p. 10164):

> Even if there were no valid objections in principle to this measure, nevertheless there has not been sufficient study made to enable the Congress to provide—through exemptions—relief to the

[4] In the hearings before both Committees of Congress, attention was repeatedly called to the situation of companies located in such states. Hearings before the Committee on Ways and Means, House of Representatives, 74th Cong., 2d Sess., pp. 101–102, 836–837, 842, 846–847; Hearings before the Committee on Finance, United States Senate, 74th Cong., 2d Sess., on H. R. 12395, pp. 234, 251–262, 269, 282, 417.

following classes of business concerns which are distinctly penalized:

1. Those with deficits.

* * * * *

In addition the following business concerns are undoubtedly discriminated against:

* * * * *

3. Those prohibited by State laws from making dividend distribution if their capital is thereby impaired. Thirty-six States have such laws prohibiting directors from declaring dividends under such circumstances.

It should also be noted that when the bill which subsequently became the Revenue Act of 1938 was reported to the House of Representatives, the Committee on Ways and Means stated that one of the principal objections to the surtax on undistributed profits imposed by the Revenue Act of 1936 was that it was unfair to corporations with impaired capital which under state law cannot legally declare dividends. It was for that and other reasons that Congress substantially modified the undistributed profits tax imposed by the Revenue Act of 1938. (H. Rep. No. 1860, 75th Cong., 3d Sess., pp. 3–4.) No provision analogous to Section 26 (c) (1) appears in that Act, but certain relief for deficit corporations was afforded by the consent dividends credit provided for in Section 28 of that Act. With reference to that section the Committee made the following statement (H. Rep. No. 1860, *supra*, p. 24):

SECTION 28. CONSENT DIVIDENDS CREDIT

One of the principal objections which has been urged to any form of corporation tax measured by undistributed profits has always been that

> many corporations, for a variety of reasons, find it difficult, if not impossible, in certain situations to declare dividends in cash or scrip or to distribute taxable stock dividends. Section 28 of the bill is intended to provide a method whereby such a corporation, with the cooperation of its shareholders, may obtain the tax benefits incident to actual distribution without violation of any contractual commitment or any rule of law which might prevent it, in whole or in part, from distributing its earnings and without depriving the Government of the revenue which would flow from the receipt of dividends by the shareholders.

The legislative history of the Act thus supports the view that the failure of Congress to provide specifically for the relief of deficit corporations was deliberate and that Congress did not consider that the provisions granting relief to corporations having a written contract executed by them not to pay dividends afforded relief to corporations prohibited by state law from making distributions except from earnings.

The Bureau of Internal Revenue has consistently held that the charter of a corporation does not constitute a written contract executed by the corporation within the meaning of Section 26 (c) of the Revenue Act of 1936. Article 26–2 of Regulations 94, *infra*, pp. 20–22, promulgated under the statute here involved, so provides. See also T. D. 4674, XV–2 Cum. Bull. 53, 58 (1936). In I. T. 3016, XV–2 Cum. Bull. 73 (1936), it was specifically held that a corporation which was restricted by state law from paying dividends while its capital remained impaired was not entitled to special treatment under Section 26 (c) (1).

If, therefore, the taxpayer was in fact prohibited by the state law from distributing its 1936 earnings, it is nevertheless not entitled to any credit under Section 26 (c) (1).

3. The petitioner contends (Br. 19–22) that if Section 26 (c) (1) be construed as not including cases where a corporation is forbidden by state law from paying dividends it violates the Fifth Amendment because based upon an arbitrary classification.

We question whether any failure to provide for a deduction or credit could violate the Fifth Amendment, since all deductions are discretionary with Congress. But if we are wrong in that view, we submit that there was a rational basis for the distinction made here between contracts not to pay dividends and state laws prohibiting the payment of dividends under certain conditions. It is a comparatively easy matter for the Bureau of Internal Revenue to ascertain whether a written contract prohibits the payment of a dividend. But, as we have hitherto suggested, it would greatly burden the Bureau to have to determine the applicability in each case of the particular state statutes restricting the payment of dividends. That would involve not only an examination of the state law and practice, but also the entire financial history of every corporation. Taxing statutes must yield sometimes to the exigencies of administration (see *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, 365), and the income tax laws do not profess to embody perfect economic theory (*Helvering* v. *Midland Mutual Life Ins. Co.*, 300 U. S. 216, 225). The Constitution does not require

precise and scientific uniformity in taxing statutes. *Welch* v. *Henry*, 305 U. S. 134; *Helvering* v. *Nat. Grocery Co.*, 304 U. S. 282.

4. Even if Section 26 (c) (1) were susceptible of the construction which the petitioner places upon it, we submit that the petitioner has not shown that it was prohibited by state law from paying out all or a part of its current earnings as dividends, and hence that it is not entitled to reduce the net income subject to the tax by the amount of those earnings.[5]

It was stipulated that as of January 1, 1936, the petitioner had a deficit of $21,251.40, but that its records prior to January 1, 1929, were not susceptible of analysis to show definitely whether this deficit occurred from operating losses or capital distributions in excess of earnings or was effected by other adjustments (R. 12). No dividend distributions had been made by the petitioner since March, 1930, when $9,672 was distributed from then existing surplus (R. 12).

Section 4543 of the North Dakota statutes (*infra*, pp. 19–20) prohibits the directors of a corporation from paying dividends "except from the surplus profits arising from the business thereof * * *." But the taxpayer here has not sustained the burden of proving that it had such a deficit as would have prohibited the payment of dividends.[6] For example, we do not know whether or not the deficit resulted from prior capital

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[5] Neither the Board nor the court below found it necessary to pass upon this point, although it was presented to both.

[6] In *Lark Equity Exchange* v. *Jones*, 42 N. D. 145, it was held that a corporation seeking to recover dividends claimed to have been paid in violation of Section 4543 [illegible] the burden of proving that an actual deficit existed.

distributions, and there is considerable authority that in determining the profits available for dividends it is immaterial that some portion of the capital has been lost in a prior year and has not since been made good. II Cook on *Corporations,* 8th ed., Sec. 546, pp. 1895–1906.[7] The fact that the books of the petitioner showed a deficit is thus not conclusive that the distribution of the 1936 earnings as a dividend was prohibited under the North Dakota statutes.

CONCLUSION

There is no conflict of decisions, the question presented is not of great importance, and the decision below is probably correct. It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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JANUARY, 1940.

[7] We have found no North Dakota cases dealing with this question.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

* * * * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) *Imposition of tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

17 per centum of the portion of the undistributed net income which is in excess of 20 per centum and not in excess of 40 per centum of the adjusted net income.

22 per centum of the portion of the undistributed net income which is in excess of 40 per centum and not in excess of 60 per centum of the adjusted net income.

27 per centum of the portion of the undistributed net income which is in excess of 60 per centum of the adjusted net income.

(c) *Adjusted Net Income Less Than $50,000.*—

(1) *Specific Credit.*—If the adjusted net income is less than $50,000, there shall be allowed a specific credit equal to the portion of the undistributed net income which is in excess of 10 per centum of the adjusted net income and not in excess of $5,000, such credit to be applied as provided in paragraph (2).

(2) *Application of Specific Credit.*—If the corporation is entitled to a specific credit, the tax shall be equal to the sum of the following:

(A) A tax computed under subsection (b) upon the amount of the undistributed net income reduced by the amount of the specific credit, plus

(B) 7 per centum of the amount of the specific credit.

* * * * *

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(c) *Contracts Restricting Payment of Dividends.*—

(1) *Prohibition on Payment of Dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such

credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) *Disposition of Profits of Taxable Year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

(3) *Double Credit not Allowed.*—If both paragraph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

* * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the tax-

able year), without regard to the amount of the earnings and profits at the time the distribution was made.

* * * * *

North Dakota Compiled Laws—Supplement—(Annotated), 1913–1925:

SEC. 4543. *Dividends only from profits; limitations of indebtedness; exceptions.*—The directors of corporations must not make dividends except from the surplus profits arising from the business thereof; nor must they divide, withdraw or pay to the stockholders, or any of them, any part of the capital stock, nor must they create debts beyond the subscribed capital stock, or reduce or increase the capital stock, except as specially provided by law; provided, however, that the above limitation as to the creation of debts shall not apply to the policy risks of insurance companies on which no loss has occurred, or the notes, bonds or debentures of any loan or trust company or public utility, company or corporation, organized under the provisions of this chapter, when payment of such notes, bonds or debentures shall be secured by the actual transfer of real estate by trust deed or mortgage for the payment of such notes, bonds or debentures, which said real estate so transferred shall be of twice the value of the par value of such notes, bonds and debentures; provided further that the limitation as to the value of property conveyed by trust, deed or mortgage shall not apply to the bonds or debentures of public-utility corporations; provided, further, that such limitation shall not apply to any loan or trust company's guarantee of payment after transfer of any note, bond or debenture when the same is secured by trust deed or mortgage as above stated; provided, further that the above limitation as to the creation of debts shall not apply to certificates and debentures

issued by investment companies for the creation of an investment fund where the holder of such certificates or debentures shall by the terms of the same, participate in the earnings of such investment fund. (Laws 1925, ch. 109, § 1.)

SEC. 4543a. *To what corporations applicable.*—The provisions of this act shall apply to corporations heretofore and hereafter organized. (Laws 1925, ch. 109, § 2.)

SEC. 4544. *Penalty for violation of statute.*—For a violation of the provisions of the last section (§4543), the directors under whose administration the same may have happened, except those who may have caused their dissent therefrom to be entered at large on the minutes of the directors at the time, or were not present when the same did happen, are in their individual and private capacity, jointly and severally liable to the corporation, and to the creditors thereof, in the event of its dissolution, to the full amount of the capital stock so divided, withdrawn, paid out, or reduced, or debt contracted. There may, however, be a division and distribution of the capital stock of any corporation which remained after the payment of all its debts, upon its dissolution or the expiration of its terms of existence. No action or proceeding to enforce or recover any penalty, forfeiture or liability hereunder shall be commenced more than six months after the aggrieved party shall have had actual notice of the violation of the preceding section (§4543). (Laws 1919, ch. 100, §1.)

Treasury Regulations 94 (1936 ed.), promulgated under the Revenue Act of 1936:

ART. 26–2. *Credit in connection with contracts restricting payment of dividends.*—(a) The credit provided in section 26 (c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of divi-

dends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c). The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

If a corporation is restricted with respect to the payment of dividends by two or more contract provisions coming within section 26 (c) (1), only the largest of the credits computed with respect to each of such provisions, and not their sum, shall be allowable under section 26 (c) (1), and, for such purpose, if two or more credits are equal in amount, only one shall be taken into account. However, section 26 (c) (3) provides that if both section 26 (c) (1) and section 26 (c) (2) apply, only the one of such paragraphs which allows the greater credit shall be applied, and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

(b) *Prohibition on payment of dividends.*— The credit provided in section 26 (c) (1) is allowable only with respect to a written contract executed by the corporation prior to May 1, 1936, which expressly deals with the payment of dividends and operates as a legal restriction upon the corporation as to the amounts which it can distribute within the taxable year as dividends.

If an amount can be distributed within the taxable year as a dividend—

(1) in one form (as, example, in stock or bonds of the corporation) without violating the provisions of a contract, but can not be distributed within the taxable year as a dividend in another form (as, for example, in cash) without violating such provisions, or

(2) at one time (as, for example, during the last half of the taxable year) without violating the provisions of a contract, but can not be distributed as a dividend at another time within the taxable year (as, for example, during the first half of the taxable year) without violating such provision—

then the amount is one which, under section 26 (c) (1), can be distributed within the taxable year as a dividend without violating such provisions.

The credit provided in section 26 (c) (1) is equal to the excess of the adjusted net income, as defined in section 14 (a), over the aggregate of the amounts which can be distributed within the taxable year without violating the provisions of such contract. The requirement that the provisions of the contract expressly deal with the payment of dividends is not met in case (1) a corporation is merely required to set aside periodically a sum to retire its bonds, or (2) the contract merely provides that while its bonds are outstanding the current assets shall not be reduced below a specified amount.

The computation of the credit allowable under section 26 (c) (1) may be illustrated by the following examples:

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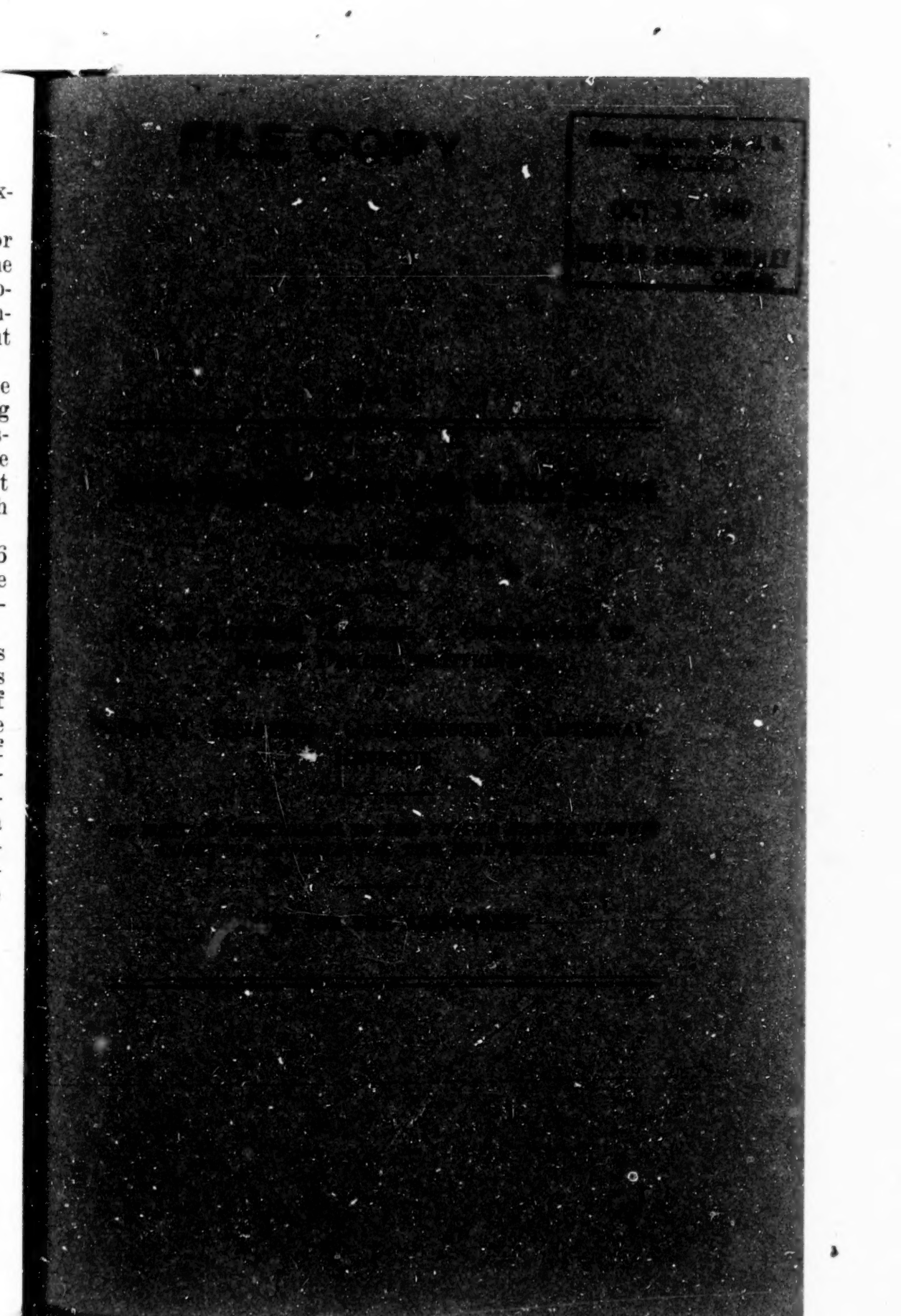
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In the Supreme Court of the United States

OCTOBER TERM, 1940

No. 8

CRANE-JOHNSON COMPANY, A CORPORATION OF NORTH DAKOTA, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 14–21) is reported in 38 B. T. A. 1355. The opinion of the Circuit Court of Appeals (R. 41–45) is reported in 105 F. (2d) 740.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered August 8, 1939. (R. 45–46.) A petition for rehearing was denied on September 15, 1939. (R. 46.) The petition for a writ of certiorari was filed December 12, 1939, and was denied

on January 15, 1940. On March 25, 1940, the Court entered an order granting the petitioner's motion for leave to file a petition for rehearing, granting the petition for rehearing, vacating the order denying certiorari, and granting the petition for a writ of certiorari. The jurisdiction of this Court is conferred by Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

The adjusted net income of the petitioner for the year 1936 was $12,032.72. As of January 1, 1936, the petitioner had a deficit of at least $21,-251.40, the origin of which does not appear. No distributions to the stockholders were made during the year. A North Dakota statute prohibits the directors of a corporation from paying dividends "except from the surplus profits arising from the business thereof". The questions presented are:

1. Whether the North Dakota statute in conjunction with petitioner's charter or certificates of stock constitutes "a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends", within the meaning of the credit provisions of Section 26 (c) (1) of the Revenue Act of 1936.

2. Whether the undistributed profits tax, as applied to petitioner, violates the Fifth Amendment to the Constitution.

3. Whether petitioner has shown that it was prohibited by state law from paying out all or a part of its adjusted net income for 1936 as dividends.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations will be found in the Appendix, *infra*, pp. 55–62.

STATEMENT

The facts as stipulated (R. 12–13) and as found by the Board of Tax Appeals (R. 14) may be summarized as follows:

The petitioner was incorporated in 1903 under the laws of North Dakota (R. 12, 14). As of January 1, 1936, it had a deficit of at least $21,251.40.[1] The records of the corporation prior to January 1, 1929, are not susceptible of analysis to show definitely whether this deficit occurred from operating losses or capital distributions in excess of earnings, or was effected by other adjustments (R. 7, 12, 14).

No dividend distributions have been made by the petitioner since March 1930, when $9,672 was distributed from surplus balance existing at that time (R. 12).

[1] The deficit shown on the books and on the balance sheet accompanying the return of income was $22,876.40, but an audit made by a firm of certified public accountants showed a deficit less than that amount by $1,625. The difference resulted from the auditor's correction of the value of treasury stock (R. 12).

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The petitioner's net income for 1936 was $13,450.76. Its adjusted net income for that year was $12,032.72 (R. 13, 14).

In its return for 1936 the petitioner claimed a credit under Section 26 (c) (1) of the Revenue Act of 1936 in the computation of the surtax on undistributed profits. The Commissioner disallowed this credit, determined a surtax of $1,707.36 on undistributed profits, and assessed a deficiency in that amount (R. 12–13). The Board of Tax Appeals sustained the Commissioner's action (R. 21–22), and the Circuit Court of Appeals affirmed (R. 45).

SUMMARY OF ARGUMENT

I

1. Section 26 (c) (1) of the Revenue Act of 1936 provides that in computing the undistributed profits tax imposed by Section 14 of the Act, a credit shall be allowed if the taxpayer corporation cannot distribute dividends "without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends." The basic issue in this case is whether a North Dakota statute prohibiting the directors of a corporation from paying dividends except from surplus profits, taken in conjunction with petitioner's charter, constitutes "a provision of a written contract executed by the corporation" within the meaning of Section 26 (c) (1).

Petitioner's argument is that its charter constitutes a written contract and that the North Dakota statute should be treated as part of that contract. The argument is unrealistic. In normal parlance, the words "a provision of a written contract executed by the corporation" neither connote nor comprehend the provisions of a state regulatory statute. In popular understanding, a "statute" is a very different thing from a "contract." A contractual restraint upon the distribution of earnings is one imposed by the voluntary act of the corporation; a statutory restraint is one imposed by the state legislature without any voluntary act by the corporation. The two restraints are of different character and in common speech they are always differently characterized. Elementary principles of statutory construction, therefore, preclude the contention that when Congress used the words "a provision of a written contract executed by the corporation" it intended thereby to embrace the corporation laws of the various states. Had it had this intention, it would have been a simple matter for it to have said so.

The same conclusion follows if the language of Section 26 (c) (1) is examined literally. The credit is allowed only in the case of a contract "executed" by the corporation. This plainly means a contract which the corporation has signed. Corporate charters are executed by individuals desiring to incorporate and by the issuance to them

of a certificate of incorporation by the state. The corporation itself has no existence until the certificate is issued and it obviously does not execute the articles of incorporation.

Moreover, even though a corporate charter be deemed to be a written contract executed by the corporation, a state law restricting the payment of dividends cannot properly be deemed to be a "provision" of that contract. The most obvious and rational meaning of the words "a provision of a written contract" is a provision expressly written into the contract and not one that is implied. A state law is not expressly written into a corporate charter; at most, the corporation by accepting the charter enters into an implied agreement that it will abide by the law. It would be a strained and unnatural interpretation to construe such an implied agreement as making a state law a provision of a written contract.

There are practical considerations, too, which strongly indicate that Congress could not have intended Section 26 (c) (1) to apply to state laws restricting the payment of dividends. It is relatively easy for the Bureau of Internal Revenue to determine whether a corporation has signed what is commonly thought of as a written contract prohibiting dividend payments, but if Section 26 (c) (1) is construed as referring to state laws prohibiting the payment of dividends, the Bureau will be required to determine in every case what the state

law is, how it is administered in practice, and whether the particular corporation was so situated that a payment of dividends by it would have violated the state law. This would place an intolerable burden upon the Bureau and one which Congress could scarcely have wished to impose.

Remaining doubt, if any, as to the meaning of Section 26 (c) (1) is dispelled by the legislative history of its enactment. This shows that the failure of Congress to afford relief to corporations restrained by state laws from paying dividends was deliberate. The attention of Congress was repeatedly called to the situation of such corporations. The House bill contained a provision which gave them some relief, but that provision was stricken out. The situation of deficit corporations was one of the motivating reasons for the changes made in the undistributed profits tax by the Revenue Act of 1938.

Treasury regulations and Bureau of Internal Revenue rulings have consistently held that a charter is not a written contract executed by the corporation within the meaning of Section 26 (c) (1). This administrative construction should not be overturned in view of the practical difficulties which would flow from any other interpretation.

2. Petitioner's alternative argument, not raised before the Board or properly presented to the court below, that its stock certificates were written con-

tracts executed by it and that the North Dakota statute was a part of such contracts, is untenable. Although stock certificates containing express restrictions against dividend payments would come under Section 26 (c) (1), a state law restricting dividend payments, which is at best an implied provision of the stock certificates, does not satisfy the requirements of the section.

II

There is no merit in petitioner's argument that if it is not entitled to credit under Section 26 (c) (1), the undistributed profits tax, as applied to it, violates the Fifth Amendment. The only constitutional question raised in the petition for certiorari was one of arbitrary and unreasonable classification and consequently that is the only issue under the Fifth Amendment discussed in this brief.

Congress was clearly justified in drawing a distinction between corporations having undistributed net income and corporations not having undistributed net income. Before enactment of the undistributed profits tax, corporate income which was distributed was taxable to the stockholders, whereas corporate income which was undistributed escaped such taxation. This not only created an inequality in the tax burden imposed upon the earnings of different corporations, but also provided a means for stockholders to avoid surtaxes on their individual incomes. Moreover, there was in-

equality in the tax upon the earnings of corporations and of unincorporated enterprises, such as partnerships, since partnership income was taxable to the partners whether distributed or not. The Congressional purpose to remove these inequalities and to eliminate surtax avoidance constitutes ample justification for the different treatment accorded distributed and undistributed income.

The fact that Congress granted a credit to corporations under certain types of contractual restraints against the payment of dividends and denied the credit to corporations under other types of restraints, furnishes no ground for attack under the Fifth Amendment. Deductions and credits are a matter of legislative grace; consequently, the allowance of one deduction and the failure to grant another cannot be said to violate the due process clause. Moreover, there was clearly a rational basis for the distinction drawn by Congress. As pointed out, it is a comparatively easy matter for the Bureau of Internal Revenue to ascertain whether a corporation has executed a written contract which expressly prohibits it from paying dividends, but it would impose an intolerable administrative burden on the Bureau if it were required to determine whether a corporation was prevented from distributing its earnings by virtue of state law. This practical consideration alone warrants the classification made by Congress.

III

The decision below must be affirmed even should the court reject the foregoing arguments, because the petitioner has not sustained the burden of proving that it was in fact prohibited by state law from distributing its adjusted net income for 1936.

ARGUMENT

INTRODUCTORY

This case presents the question of the proper construction of a portion of the undistributed profits tax law enacted by Congress as part of the Revenue Act of 1936. This Act, while continuing the normal tax upon corporate income, imposed a surtax at graduated rates upon such of the corporate profits as were not distributed during the tax year by way of dividends. The major purposes of the surtax were to equalize the tax burden on all corporate income, whether distributed to or withheld from the stockholders, and to prevent the avoidance of surtax by individual stockholders through the impounding of corporate profits in surplus. See H. Rep. No. 2475, 74th Cong., 2d Sess., pp. 1–3.

The formula for computation of the tax is set forth in Section 14, *infra,* pp. 55–56. The basis of the tax is that portion of the "undistributed net income" of the corporation which is in excess of specified percentages of the "adjusted net income". "Adjusted net income" is defined as net income

less certain specified credits, and "undistributed net income" is defined as the adjusted net income less the amount of the dividends paid during the tax year and less the credits provided in Section 26 (c).

Section 26 (c) is the crux of the present controversy. It was designed to afford relief from the surtax in certain narrowly limited situations to corporations which were under contractual restraint against the distribution of their profits. The pertinent provisions of the section follow:

> SEC. 26. CREDITS OF CORPORATIONS.
>
> In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—
>
> * * * * *
>
> (c) *Contracts Restricting Payment of Dividends.*—
>
> (1) *Prohibition on Payment of Dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. * * *
>
> (2) *Disposition of Profits of Taxable Year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision ex-

pressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. * * *

(3) *Double Credit Not Allowed.*—If both paragraph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

The narrow scope of the relief afforded by Section 26 (c) (1) is apparent. It does not apply to a corporation which is prevented from distributing income pursuant to the terms of an oral contract. See *Northwest Steel Rolling Mills, Inc.* v. *Commissioner,* 110 F. (2d) 286, 288 (C. C. A. 9th). It does not apply to a corporation which is prevented from distributing income pursuant to a contract entered into after May 1, 1936. It does not apply to a corporation which is prevented from distributing income pursuant to a contractual obligation, such as that embodied in many mortgage indentures and preferred stock certificates, requiring it to maintain its net assets at a certain ratio to its liabilities, or to maintain its net tangible assets at a certain amount, since such a provision does not deal "expressly" with the payment of dividends. Treasury Regulations 94, Article 26–2 (b), *infra*

pp. 61–62; see Note (1936) 50 Harv. L. Rev. 332, 340. In other words, no restraint upon the distribution of profits, whether the restraint be imposed by law, by contract or by sound business policy, furnishes ground for relief except a restraint expressly imposed by "a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends."

Petitioner seeks to bring itself within the scope of Section 26 (c) (1) by urging (1) that since it had a deficit in 1936 of a larger amount than its earnings for that year, it was prohibited by a North Dakota statute from distributing any dividends;[2] and (2) that the North Dakota statute constitutes a part of the charter of the corporation and therefore should be treated as "a provision of a written contract executed by the corporation prior to May 1, 1936" within the meaning of Section 26 (c) (1).[3]

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[2] Section 4543 of the North Dakota Compiled Laws, 1913–1925, *infra*, pp. 58–59, prohibits the directors of a corporation from paying dividends "except from the surplus profits arising from the business thereof * * *." Section 4544, *infra*, pp. 59–60, imposes a civil liability on directors who violate this provision. Similar provisions were in effect in 1903 when petitioner was incorporated. See Sections 2891–2892, North Dakota Revised Code (1899).

[3] In this Court petitioner makes the alternative argument that its stock certificates, in conjunction with the state statute, likewise constitute a written contract executed by the corporation. This argument was made for the first time in an unsuccessful petition for rehearing in the court below, except for an oblique reference thereto in petitioner's reply brief (pp. 5–6), and for reasons pointed out below (pp. 35–37, *infra*), we believe that it is without merit.

Petitioner further contends that if the statute should be construed as denying the relief claimed, the surtax is violative of the Fifth Amendment.

The Government's position is that a statutory provision restricting dividend payments can never constitute a provision of a written contract within the contemplation of Section 26 (c), that the statute, so construed, is clearly constitutional, and that, in any event, petitioner has failed to prove that it was prohibited by state law from distributing its 1936 profits.

I

A STATUTORY PROVISION RESTRICTING DIVIDEND PAYMENTS DOES NOT CONSTITUTE "A PROVISION OF A WRITTEN CONTRACT EXECUTED BY THE CORPORATION" WITHIN THE MEANING OF SECTION 26 (c) (1)

1. The holding of the court below that a statutory provision restricting the payment of dividends does not constitute "a provision of a written contract executed by the corporation" within the meaning of Section 26 (c) (1) is, we believe, clearly correct. The decision is in accord with *Bastian Bros. Co.* v. *McGowan,* 32 F. Supp. 93 (W. D. N. Y.), affirmed per curiam (C. C. A. 2d), July 11, 1940, 1940 C. C. H. Vol. 4, par. 9581; *Utah Hotel Co.* v. *Hinckley* (D. Utah), decided Jan. 29, 1940, found in 1940 C. C. H., Vol. 4, par. 9342, and with the consistent

rulings of the Board of Tax Appeals.[4] *Northwest Steel Rolling Mills, Inc.* v. *Commissioner,* 110 F. (2d) 286 (C. C. A. 9th), is, however, in conflict with the decision below. A petition for a writ of certiorari in the *Northwest Steel* case has been filed, No. 121, present Term.

Petitioner takes a syllogistic approach to the case. Relying upon such decisions of this Court as *Dartmouth College* v. *Woodward,* 4 Wheat. 518, it advances as its major premise that the charter of a corporation is a written contract. Its minor premise is that a state statute regulating the corporation becomes a part of the charter and therefore the provisions of the statute must be deemed to be provisions of the written contract. The conclusions drawn from these premises is that petitioner is entitled to the relief provided by Section 26 (c) (1).

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[4] See *Cooperative Publishing Co.* v. *Commissioner,* 40 B. T. A. 465, and the unreported memorandum opinions in the following cases: *McBrides, Inc.* v. *Commissioner,* decided June 20, 1939; *Stein Wholesale Dry Goods Co.* v. *Commissioner,* decided January 8, 1940; *Border Queen Kitchen Cabinet Co.* v. *Commissioner,* decided January 8, 1940; *Saginaw Timber Co.* v. *Commissioner,* decided January 18, 1940; *American National Realty Co.* v. *Commissioner,* decided January 31, 1940; *Ingersoll Amusement Co.* v. *Commissioner,* decided January 31, 1940; *Clovis Hotel Co.* v. *Commissioner,* decided February 7, 1940; *Thompson Land and Livestock Co.* v. *Commissioner,* decided February 9, 1940; *Forest T. Ellis* v. *Commissioner,* decided February 9, 1940.

We challenge the validity both of the approach and of the syllogism. The question here is simply one of the intent of Congress in enacting Section 26 (c) (1); to ascertain this intent, resort should not be had to syllogistic reasoning but to "the plain, obvious and rational meaning" of the words used in the statute. *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364, 370; *Old Colony R. Co.* v. *Commissioner*, 284, U. S. 552, 560, and cases cited.[5] And the words employed by Congress are presumed to have been used "in their known and ordinary signification." *Levy's Lessee* v. *McCartee*, 6 Pet. 102, 110; *Old Colony R. Co.* v. *Commissioner, supra.*

Here the words used are "a provision of a written contract executed by the corporation". Certainly in normal parlance those words neither connote nor comprehend the provisions of a state regulatory statute. In popular understanding, a "statute" is a very different thing from a "contract"; each term has its own accepted meaning and neither term includes the other. A contractual restraint upon the distribution of earnings is one imposed by the voluntary act of the corporation; a statutory restraint is one imposed by the state legislature without any voluntary act by the corporation. The two restraints are of different character and in common speech they are always differently

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[5] Accord: *Woolford Realty Co.* v. *Rose*, 286 U. S. 319; *Old Colony Trust Co.* v. *Commissioner*, 301 U. S. 379; *Magnano Co.* v. *Hamilton*, 292 U. S. 40.

characterized.[6] In these circumstances, elementary principles of statutory construction preclude the contention that when Congress used the words "a provision of a written contract executed by the corporation", it intended thereby to embrace the corporation laws of the various states. As the district court pointed out in *Bastian Bros.* v. *McGowan, supra,* if Congress had meant to include statutory as well as contractual restraints within the scope of Section 26 (c) (1), it would have a been a simple matter for it to have said so. Its failure to say so shows that it had no such intention. Cf. *Kessler* v. *Strecker,* 307 U. S. 22, 29.

The same result follows if we approach the question, as petitioner would have us do, by literal examination of the language employed in Section 26 (c) (1). We do not deny that, for purposes of the "contract clause" of the Constitution, a charter is held to be a contract between the state and the corporation or its stockholders. *Dartmouth College* v. *Woodward,* 4 Wheat. 518; *Home Bldg. & L. Assn.* v. *Blaisdell,* 290 U. S. 398; *The Binghamton Bridge,* 3 Wall. 51; *Jefferson Branch Bank*

[6] For example, the witnesses who appeared before the Congressional committees consistently drew a distinction between contractual restraints upon the distribution of earnings and similar restrictions imposed by requirement of law. See, e. g., Hearings Before House Committee on Ways and Means, 74th Cong., 2d Sess., on the Revenue Act of 1936, pp. 807, 836, 846; Hearings Before Senate Committee on Finance, 74th Cong., 2d Sess., on H. R. 12395, pp. 111, 122, 245, 269, 285, 291, 295.

v. *Skelly,* 1 Black 436; *Personal Industrial Bankers* v. *Citizens Budget Co.,* 80 F. (2d) 327, 328 (C. C. A. 6th). Nor do we deny that laws which exist at the time of the making of a contract and which affect its validity, construction, discharge, or enforcement enter into and form a part of the contract as though they were incorporated in its terms. *Home Bldg. & L. Assn.* v. *Blaisdell, supra; Farmers Bank* v. *Federal Reserve Bank,* 262 U. S. 649. But the language of Section 26 (c) (1) provides at least three barriers to proceeding from these premises to the conclusion that the North Dakota statute here involved, taken in conjunction with petitioner's charter, is "a provision of a written contract executed by the corporation".

In the first place, a corporate charter is not a contract "executed" by the corporation. The ordinary meaning of the word "executed," when used with reference to a written instrument, is "signed" or "signed, sealed and delivered" (*Bouvier's Law Dictionary,* (Rawle's 3rd Revision) Vol. I, p. 1111; *Words and Phrases* (1st series), Vol. III, p. 2558; *Id.* (2nd series) Vol. II, pp. 378–379); as pointed out above, words employed in a taxing statute, as in other statutes, are to be given their common or ordinary meaning. See cases cited, p. 16, *supra.* It seems clear, therefore, that Section 26 (c) (1) applies only to a written contract which the corporation has signed. Corporate charters are secured through the filing of articles

of incorporation by individuals desiring to incorporate and by the issuance of a certificate of incorporation by the state. The corporation itself has no existence until the certificate is issued, and it obviously does not execute the articles of incorporation. The majority of the court in the *Northwest Steel* case thought it sufficient that the corporation became bound by the acts of the incorporators on the theory of a novation, ratification or continuing offer. But, as pointed out by Judge Haney in his dissenting opinion in that case, this construction makes the word "executed" superfluous. It is an elementary rule of statutory construction that words used in a statute are not to be treated as surplusage where they may reasonably be given effect. *Platt* v. *Union Pacific R. R. Co.*, 99 U.S. 48; *McDonald* v. *Thompson*, 305 U.S. 263. It follows that a charter does not constitute a written contract executed by the corporation within the meaning of Section 26 (c) (1). See Note (1936) 50 Harv. L. Rev. 332, 340; cf. Note (1936) 36 Col. L. Rev. 1321, 1343.

In the second place, even though a corporate charter be deemed to be a written contract executed by the corporation, a state law restricting the payment of dividends cannot properly be deemed to be a "provision" of that contract within the meaning of Section 26 (c) (1). The most obvious and rational meaning of the words "a provision of a written contract" is a provision ex-

pressly written into the contract and not one that is implied. A state law, of course, is not expressly written into corporate charters; at most, the corporation, by accepting the charter, enters into an implied agreement that it will abide by the law. It would be a strained and unnatural interpretation to construe such an implied agreement as making the state law a provision of a written contract.

In the third place, the particular state statute involved in this case imposes a restriction against the payment of dividends upon the directors of the corporation, but not upon the corporation itself. While we believe it clear that petitioner could not maintain its position even though the prohibition operated directly upon the corporation, its position is even more untenable where, as here, maintenance of that position depends upon establishing the proposition that in accepting the charter the corporation undertakes a contractual obligation that its directors will not pay dividends except from surplus profits.

Thus, whether we approach the question of statutory construction realistically, by ascertaining the plain, obvious, and rational meaning of the language employed in Section 26 (c) (1), or whether we approach it legalistically, by ascertaining the literal meaning of the language, we arrive at precisely the same result. And the conclusion thus reached is supported by consideration of the provisions of Section 26 (c) (2) which

are in *pari materia* with those of Section 26 (c) (1). Section 26 (c) (2) provides for a credit equal to such of the earnings of the taxable year as are required "by a provision of a written contract executed by the corporation prior to May 1, 1936," to be paid in discharge of a debt or to be irrevocably set aside for the discharge of a debt. Since, so far as we have been able to ascertain, no state imposes as a requirement of law that corporate debts shall be discharged out of earnings, the words "a provision of a written contract executed by the corporation," as used in Section 26 (c) (2), must obviously refer only to voluntary corporate undertakings. The same words, as used in the cognate provisions of Section 26 (c) (1), should, of course, be similarly construed in the absence of any compelling reasons to the contrary.

There are practical considerations, too, which strongly indicate that Congress could not have intended Section 26 (c) (1) to apply to state laws restricting the payment of dividends. These laws are extremely varied and state courts construing similar provisions construe them differently. It would serve no useful purpose to enumerate all of the differences in this brief, but it may be pointed out that even under similar statutes the state courts differ in their treatment of appreciation in the value of assets, depreciation and depletion, good will and many other items. Many of the differences are pointed out in a series of articles en-

Remaining doubt, if any, as to the meaning of Section 26 (c) (1) is resolved by the legislative history of its enactment. The bill which, as enacted, became the Revenue Act of 1936, contained, in the form in which it was reported to and passed by the House, three distinct provisions designed to relieve corporations which for various reasons could not or should not pay dividends. Section 14 (a) provided that if the accumulated earnings and profits of the corporation as of the close of the taxable year (computed without diminution by reason of the distribution during the taxable year of earnings and profits, or by reason of the taxes imposed by Title I of the Act) were less than the adjusted net income, the tax should be computed in a different manner. This provision was intended to relieve corporations having a deficit. Section 15 was designed for the relief of corporations under contractual restraint against the payment of dividends, and Section 16 was designed for the relief of corporations having outstanding indebtedness. H. R. 12395, 74th Cong., 2d Sess., Secs. 14, 15, and 16.

In explanation of those provisions the Committee on Ways and Means stated (H. Rep. No. 2475, 74th Cong., 2d Sess., pp. 8–9):

EXCEPTIONS FROM GENERAL PLAN.

> It has been recognized that in certain cases corporations cannot pay out dividends or that sound policy demands the nonpay-

ment of dividends. Therefore, in certain cases, a flat rate of tax is imposed on corporate incomes, or parts thereof, in lieu of the undistributed profits tax proposed in the general case.

Deficits.—For example, section 14 of the bill provides that corporations with a deficit shall pay a tax of 22½ percent on the amount of earnings necessary to make up this deficit and only come under the new plan in respect to earnings in excess of this deficit, and in excess of the tax paid at the 22½ percent rate. This rule is more accurately stated in the section.

Contracts not to pay dividends.—In section 15 a similar treatment is accorded in respect to that part of corporate net income that cannot be paid out in dividends without violating a written contract in existence prior to March 3, 1936.

Debts.—In section 16 similar relief is given in case of certain debts which are in excess of the accumulated earnings and profits.

It is also provided that sections 14, 15, and 16 noted above shall not operate to increase the tax which would be payable without the application of such sections. A corporation, however, cannot use more than one of the relief provisions just cited but must use the one which will result in the smallest tax.

The Senate Committee on Finance substituted for the graduated undistributed profits tax provided for in the House bill, a flat surtax of 7%

on undistributed profits. It also struck out Sections 14, 15, and 16 of the House bill, but in Section 26 (c) (1) retained the principle of Section 15 of that bill affording relief to corporations under contractual restraint against the payment of dividends.

In explanation of these changes the Committee stated in its report (S. Rep. No. 2156, 74th Cong., 2d Sess., pp. 12–13, 15):

SURTAX ON UNDISTRIBUTED PROFITS

Section 14 of the committee bill imposes a surtax of 7 percent upon the amount of the undistributed net income of corporations. This, together with the normal tax on corporations, is a complete substitution for the undistributed-profits tax provision of the House bill. Instead of having a graduated undistributed-profits tax like the House bill with rates ranging as high as 42.5 percent, your committee has adopted a flat rate of 7 percent. *By this moderate rate your committee has eliminated most of the complicated relief provisions in the House bill relating to debt and deficit corporations. However, the principle of the House bill affording relief to corporations which are unable to pay dividends because of express prohibitions in contracts entered into prior to March 3, 1936, have been retained for the purpose of the 7-percent undistributed-profits tax.*

The term "undistributed net income" is defined in the bill to mean the adjusted net

income minus (1) dividends paid during the taxable year, and (2) the amount of the adjusted net income which the corporation is prohibited by contract as defined in section 26 (c) from paying as dividends during the taxable year. The adjusted net income consists of the net income of the corporation reduced by the following:

(1) The normal tax on corporations imposed by section 13;

(2) Interest on United States and Government obligations;

(3) The amount allowed as a credit to a bank holding company affiliate under section 26 (d).

* * * * *

SECTION 26. CREDITS OF CORPORATIONS.

This section sets forth certain credits allowed to corporations in computing the various taxes imposed under title I. In general, they are as follows:

* * * * *

(3) Contracts not to pay dividends: This credit is in principle similar to a relief provision allowed in the House bill for the purpose of the undistributed-profits tax imposed by that bill. It is allowed as a credit in computing undistributed net income for the purpose of the surtax on undistributed profits imposed by section 14 and in computing retained net income for the purpose of the tax imposed by section 102. [Italics supplied.]

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An amendment to Section 26 (c) on the floor of the Senate restored the credit allowed to corporations under contractual obligation to pay indebtedness which had been contained in Section 16 of the House bill. Section 26 (c) (2); 80 Cong. Rec., Part 8, 74th Cong., 2d Sess., pp. 8790–8791, 9071. A graduated rate was also substituted for the flat surtax rate which the Senate Finance Committee had recommended. But no provision for the relief of deficit corporations analogous to Section 14 of the House bill was adopted. See H. Conference Rep. No. 3068, 74th Cong., 2d Sess., pp. 2–4. See also 80 Cong. Rec., Part 8, *supra*, p. 9071.

By a change in the definition of a dividend (see Section 115 (a) of the Revenue Act of 1936, *infra*, p. 58), the bill as passed permitted a dividends-paid credit to deficit corporations which actually distributed current earnings (see Section 27 of the Revenue Act of 1936), but none was allowed to deficit corporations which did not distribute.[7]

[7] Section 115 (a) defines "dividend" as including any distribution "out of the earnings or profits of the taxable year" and obviously includes distributions made by deficit corporations having current earnings. Under this section, contrary to the implication of the statements made on pp. 39–40 of petitioner's brief, any distributions made by the petitioner during the tax year would have been taxable to its stockholders and petitioner would have been entitled to a dividends-paid credit for such distributions. *Hadden* v. *Commissioner*, 49 F. (2d) 709 (C. C. A. 2d), and *Kinnear* v.

Thus the failure of Congress to provide specifically for the allowance of a credit to corporations which had deficits and were therefore prevented by state law from paying out dividends appears to have been deliberate.[8] Section 14 of the House bill might have given them relief, but the Act as finally passed did not. It appears, moreover, that the purpose of the Senate in making the change was to eliminate the necessity of determining when there was a deficit, for, in explaining Section 115 (a), the Committee on Finance said (S. Rep. No. 2156, *supra*, p. 18):

> SECTION 115 (a). DIVIDENDS OUT OF CURRENT EARNINGS
>
> In order to enable corporations without regard to deficits existing at the beginning of the taxable year to obtain the benefit of the dividends paid credit for the purposes of the undistributed profits surtax, section 115 (a) changes the definition of a dividend so as to include distributions out of the earnings or profits of the current taxable year.

Commissioner, 36 B. T. A. 153, cited by petitioner (p. 39) arose under an earlier statute which defined the term "dividends" differently.

[8] In the hearings before both committees of Congress, attention was repeatedly called to the situation of such companies. Hearings before the House Committee on Ways and Means, 74th Cong., 2d Sess., on the Revenue Act of 1936, pp. 101–102, 836–837, 842, 846–847; Hearings before the Senate Committee on Finance, 74th Cong., 2d Sess., on H. R. 12395, pp. 234, 261–262, 269, 282, 417.

> The amendment simplifies the determination by providing that distributions during the year, not exceeding in amount the current earnings, are dividends constituting taxable income to the shareholder and a dividends paid credit to the corporation. As respects such dividends the complicated determination of accumulated earnings or profits is rendered unnecessary.

It should also be noted that Senator Walsh, a member of the Senate Finance Committee, stated on the floor of the Senate that the bill did not afford relief to corporations which were prevented by state law from declaring dividends except from surplus. He stated (80 Cong. Rec., Part 8, *supra*, p. 9058):

> Again, the laws of 36 States prohibit corporations chartered by them from making a dividend distribution if their capital is impaired. Under the proposed undistributed-profits tax, corporations affected by these provisions would be heavily penalized by the Federal tax for keeping within the law. The House bill taxes these corporations a flat rate on their net income of 22½ percent, regardless of their dividend policy.

The petitioner quotes (Br. 37) an excerpt from the minority views of Senators Walsh and George (80 Cong. Rec., Part 10, 74th Cong., 2d Sess., p. 10164), and suggests that apparently Senator Walsh, subsequent to the above-quoted statement on the floor of the Senate, had been told that he

was wrong in thinking that no relief was afforded to corporations which were prevented by state law from declaring dividends except from surplus. The excerpt is as follows:

> The defenders of the bill in the form which it has now taken contend that by sundry exemptions and modifications the smallest corporations are spared the full force of the new tax, as well as helped by the lowering of the rates on the normal corporation income tax; that the banks and insurance companies are entirely excluded; *and that in some instances corporations under contract not to pay dividends, and forbidden by law to do so, are permitted without extra penalty to apply a percentage of their earnings to reserves.* [Italics supplied.]

It will be noted that in the italicized portion of this excerpt, Senators Walsh and George did not state that corporations forbidden by state law to pay dividends would be entitled to a credit, but stated merely that in some instances they would be permitted, without extra penalty, "to apply a percentage of their earnings to reserves." The statement apparently refers to the provisions of Section 14 (c) of the Act, which provides that corporations having an adjusted net income of less than $50,000 are entitled to a specific credit, which has the effect of exempting a percentage of their earnings from the higher surtax rates imposed by Section 14 (b) and substitutes therefor a tax at 7 percent. Under this

section, small corporations are permitted to apply a percentage of their earnings to reserves and to pay a combined normal and undistributed tax thereon of only 15 percent, which is but slightly greater than the 13¾ percent normal tax imposed by the 1934 Act.

That Senators Walsh and George were not of the opinion that the Act provided relief to all corporations prevented by state law from declaring dividends is clearly shown by the statement made by them several paragraphs after the one quoted by the petitioner (80 Cong. Rec., Part 10, *supra*, p. 10164). That statement is as follows:

> * * * the following business concerns are undoubtedly discriminated against:
>
> * * * * *
>
> 3. Those prohibited by State laws from making dividend distribution if their capital is thereby impaired. Thirty-six States have such laws prohibiting directors from declaring dividends under such circumstances.

It should also be noted that when the bill which subsequently became the Revenue Act of 1938 (c. 289, 52 Stat. 447) was reported to the House, the Committee on Ways and Means stated that one of the principal objections to the surtax on undistributed profits imposed by the 1936 Act was that it was unfair to corporations with impaired capital which under state law could not legally declare dividends. It was for this reason, among others, that the undistributed profits tax was substantially

modified in the 1938 Act. See H. Rep. No. 1860, 75th Cong., 3d Sess., pp. 3–4. No provision analogous to Section 26 (c) (1) appears in the 1938 Act but certain relief for deficit corporations was afforded by the consent dividends credit provided for in Section 28. With reference to that section the Committee made the following statement (H. Rep. No. 1860, *supra,* p. 24):

> SECTION 28. CONSENT DIVIDENDS CREDIT
>
> One of the principal objections which has been urged to any form of corporation tax measured by undistributed profits has always been that many corporations, for a variety of reasons, find it difficult, if not impossible, in certain situations to declare dividends in cash or scrip or to distribute taxable stock dividends. Section 28 of the bill is intended to provide a method whereby such a corporation, with the cooperation of its shareholders, may obtain the tax benefits incident to actual distribution without violation of any contractual commitment or any rule of law which might prevent it, in whole or in part, from distributing its earnings and without depriving the Government of the revenue which would flow from the receipt of dividends by the shareholders.

Thus the legislative history of the Act supports the view that the failure of Congress to provide specifically for the relief of deficit corporations was deliberate and that it did not intend Section 26 (c) (1) to cover this situation. This, too, has been the consistent administrative interpretation.

In Article 26–2 of Regulations 94, *infra*, p. 60, promulgated under the 1936 Act, the Bureau of Internal Revenue ruled that the charter of a corporation does not constitute a written contract executed by the corporation within the meaning of Section 26 (c). See also T. D. 4674, XV–2 Cum. Bull. 53, 58 (1936). And in I. T. 3016, XV–2 Cum. Bull. 73 (1936), it was specifically held that a corporation which was restricted by state law from paying dividends while its capital remained impaired was not entitled to the relief afforded by Section 26 (c) (1). This administrative construction should not be disturbed except for weighty reasons. *Koshland* v. *Helvering*, 298 U. S. 441, 445; *Brewster* v. *Gage*, 280 U. S. 327; *Maryland Casualty Co.* v. *United States*, 251 U. S. 342; *Fawcus Machine Co.* v. *United States*, 282 U. S. 375; *National Lead Co.* v. *United States*, 252 U. S. 140; see also *Bowen* v. *Johnston*, 306 U. S. 19; *Armstrong Co.* v. *Nu-Enamel Corp.*, 305 U. S. 315. Particularly is this true where overturning the administrative construction would create great practical difficulties in the operation of the statute. See *Woolford Realty Co.* v. *Rose*, 286 U. S. 319.

Finally, the statute here involved concerns a deduction or credit. Deductions are allowed as a matter of legislative grace and provisions granting them are to be strictly construed. *White* v. *United States*, 305 U. S. 281; *New Colonial Ice Co.* v. *Helvering*, 292 U. S. 435; *Deputy* v. *duPont*, 308 U. S. 488; *Helvering* v. *Ind. Life Ins. Co.*, 292 U. S. 371;

Helvering v. *Inter-Mountain Life Insurance Co.*, 294 U. S. 686. The taxpayer invokes the rule that in construing a statute doubts are to be resolved in favor of the taxpayer, citing *Hassett* v. *Welch*, 303 U. S. 303. But that rule has no application to provisions granting deductions. *Helvering* v. *Inter-Mountain Life Insurance Co., supra.*[9]

2. Petitioner's alternative argument, that its stock certificates are written contracts with its stockholders executed by it and that the North Dakota statute prohibiting the payment of dividends constitutes a provision of those contracts,

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[9] The petitioner argues that Section 26 (c) (1) is a relief provision which should be construed liberally, citing *Old Colony Trust Co.* v. *Commissioner*, 301 U. S. 379; *Bonwit Teller & Co.* v. *United States*, 283 U. S. 258, 263; *Kelly-Springfield Tire Co.* v. *United States*, 81 F. (2d) 533 (C. C. A. 3d); *Johnston* v. *Commissioner*, 33 B. T. A. 551; and *Standifer Construction Corp.* v. *Commissioner*, 4 B. T. A. 525. The last two cases cited involved not deductions but provisions relating to the method of reporting income. The *Bonwit Teller* case, too, did not involve a deduction but a provision of a tax law giving taxpayers an opportunity to secure refunds of barred overpayments. Provisions relating to deductions have been regarded only in rare instances as relief provisions to be construed liberally in favor of the taxpayer. The *Old Colony Trust Co.* case related to a deduction for charitable contributions, and it was held that since the deduction was granted from motives of public policy, the statute allowing it was to be liberally construed. The *Kelly-Springfield Tire Co.* case concerned a provision allowing a deduction for amortization of war facilities, a liberal construction of which might conceivably be sustained on a similar ground. None of the cases supports the view that the statute here involved is a relief provision to be liberally construed in favor of the taxpayer.

was not raised in either the petition before the Board or in the petition for review filed in the court below, and neither the Board nor the court below passed upon it. Petitioner raised the issue as an affirmative argument for the first time in a petition for rehearing filed in the court below which was denied.[10]

In any event, the argument is without merit. It is true that the Bureau of Internal Revenue has ruled that stock certificates issued prior to May 1, 1936, which contain an express provision restricting dividend payments, satisfy the requirements of Section 26 (c) (1) and that this ruling assumes that a stock certificate constitutes a written contract executed by the corporation. I. T. 3139, 1937—2 Cum. Bull. 111; I. T. 3152, 1938—1 Cum. Bull. 155. But, so far as the record shows, peti-

[10] Petitioner states in its brief (p. 5) that this point was urged before the court below "in brief and oral argument." Copies of petitioner's briefs in the court below are being filed with the Clerk of this Court. Petitioner's main brief contains no argument whatever with respect to its stock certificates; its reply brief (pp. 5–6) contains several oblique references to the stock certificates, made under the heading "The Charter Is a Written Contract Executed By the Corporation," and designed as a rebuttal to the Government's contention that a charter is not "executed" by the corporation. The recollection of counsel for the Government who handled the case below, with respect to the oral argument, is that counsel for petitioner started to discuss the issue by attempting to read one of petitioner's stock certificates to the court, but that after Government counsel objected that the stock certificate was not part of the record, no further argument on the point was made.

tioner's stock certificates, like its charter, contained no provision restricting dividend payments. The argument with respect to the stock certificates is, therefore, necessarily bottomed on the proposition, already shown to be untenable, that a state statute is "a provision of a written contract executed by the corporation" within the meaning of Section 26 (c) (1). By issuing its stock, petitioner certainly made no express agreement that its directors would not distribute dividends except in accordance with state law; at most, such an agreement is implied by law. As we have pointed out, this is not sufficient to satisfy the requirements of Section 26 (c) (1); the plain, obvious, and rational meaning of the words "a provision of a written contract" is a provision expressly written into a contract and not one that is implied. Moreover, the practical considerations and legislative history which militate against petitioner's position are equally cogent whether a stock certificate or a charter is relied upon as constituting the written contract. And reliance upon the stock certificates fails utterly to answer the persistent query why, if Congress had intended statutory restraints to entitle corporations to the credit, it failed to say so expressly.

We submit, therefore, that the North Dakota statute, whether considered in conjunction with petitioner's charter or in conjunction with its stock certificates, does not entitle petitioner to the credit provided for by Section 26 (c) (1).

II

THE UNDISTRIBUTED PROFITS TAX, AS APPLIED TO PETITIONER, DOES NOT VIOLATE THE FIFTH AMENDMENT

In its petition for certiorari, the only constitutional question raised by petitioner was whether, if it was not entitled to credit under Section 26 (c) (1), the undistributed profits tax, as applied to it, violated the Fifth Amendment because of arbitrary and unreasonable classification (Pet. 2, 10–11, 20–22). In its brief on the merits, however, petitioner seeks to raise additional questions (Br. 43–48) by contending (1) that a corporate income tax is an excise which the Constitution requires to be uniform and that the undistributed profits tax, as construed by the court below, does not operate with uniformity; (2) that the tax is invalid because it is a penalty tax; (3) that the tax is an illegal regulation of the internal affairs of corporations, which is a matter reserved to the states by the Tenth Amendment; and (4) that the tax is unconstitutional because it taxes corporations for not doing an unlawful and criminal act.[11] Because of petitioner's fail-

[11] In the court below, petitioner's only constitutional argument was that the statute was invalid because it imposed a tax for failure to do an unlawful and criminal act. This point was not raised in the petition for certiorari and is not available on this record, since the North Dakota statute (*infra*, pp. 58–60) imposes a civil and not a criminal liability on directors distributing dividends otherwise than from surplus profits of the business.

ure to raise these questions in its petition for certiorari, this Court is not required to pass on them (see *Gunning* v. *Cooley*, 281 U. S. 90; *Sonzinsky* v. *United States*, 300 U. S. 506; *Connecticut Ry. Co.* v. *Palmer*, 305 U. S. 493) and consequently we will not discuss them in this brief.[12]

In considering whether the tax, as applied to petitioner, violates the Fifth Amendment because of arbitrary and unreasonable classification, it is fundamental to note that the tax is imposed, not upon distributable undistributed profits, as petitioner suggests (Br. 6), but upon all undistributed profits, whether distributable or not, with the sole exception of the comparatively few situations to which Section 26 (c) apply. Consequently, the only two possible questions of classification which may be raised are: (1) whether Congress may properly draw a distinction between corporations having undistributed net income (whether or not such income is distributable) and corporations not having undistributed net income; and (2) whether,

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[12] For the same reason, we do not discuss a number of general questions as to the constitutionality of the undistributed profits tax raised by the brief of *amici curiae* filed in support of the petition for a writ of certiorari.

Several of those constitutional arguments were raised below by the respondent in *Helvering* v. *Northwest Steel Rolling Mills, Inc.*, now pending on petition for certiorari, No. 121, present Term. If certiorari is granted in the *Northwest Steel* case, the Government will discuss these contentions in its brief in that case.

if Congress may draw this distinction, it may, for cogent reasons of administrative convenience, grant a deduction or credit to corporations prohibited from distributing their income because of certain types of contractual restraints and deny such a deduction or credit to corporations prohibited from distributing their income by reason of other types of restraints.

1. There can, we believe, be no serious constitutional attack on the undistributed profits tax on the ground that it puts corporations which do not distribute their earnings in a different class from corporations which make such distributions. This classification represents the fundamental policy of the statute. Before its enactment into law, corporate income which was distributed was taxable to the stockholders, whereas corporate income which was undistributed escaped such taxation, even though the economic benefit to the stockholders, as beneficial owners of the business, was the same in each situation. This not only created an inequality in the tax burden imposed upon the earnings of different corporations but also provided a means for stockholders to avoid surtaxes on their individual incomes. Moreover, there was inequality in the tax upon the earnings of corporations and of unincorporated enterprises, such as partnerships, since partnership income was taxable to the partners whether distributed or not, whereas stockholders avoided tax on the undistributed earn-

ings of their corporations. It was to remove these inequalities and to eliminate the avoidance of surtaxes that the tax on undistributed profits was enacted. See H. Rep. No. 2475, 74th Cong., 2d Sess., pp. 1–3.[13]

The concept of a surtax on undistributed profits was by no means a new tax theory.[14] In every revenue act since 1921, a special tax had been imposed on corporations formed or availed of to prevent, through the accumulation of profits, the imposition of surtaxes on their shareholders.[15] Section 102 of the Revenue Act of 1934 (48 Stat. 702), the imme-

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[13] A very complete history of this legislation is to be found in an article entitled "Taxation of Undistributed Corporate Profits" by John B. Martin, Jr., 35 Mich. L. Rev. 44 (1936).

[14] See Report of the Secretary of the Treasury (1920), pp. 39–41. An amendment to the Revenue Act of 1924 embodying this principle was passed by the Senate. See 65 Cong. Rec. 8033. See also Report of Joint Committee on Internal Revenue Taxation (1927), Vol. 1, p. 54; 80 Cong. Rec. 9164. At the time of the enactment of the undistributed profits tax, Belgium and Norway had similar taxes. Belgium: Law of October 29, 1919, 1919 2 Pasinomie 169; Norway: Law of July 13, 1921, 1921 Norsk Lovtidende (2nen avdeling) 341. See Tax Systems of the World (1935) 334.

[15] 1921 Act, Section 220, 41 Stat. 247; 1924 Act, Section 220, 43 Stat. 277; 1926 Act, Section 220, 44 Stat. 34; 1928 Act, Section 104, 45 Stat. 814; 1932 Act, Section 104, 47 Stat. 195; 1934 Act, Section 102, 48 Stat. 702; 1936 Act, Section 102, 49 Stat. 1676. Prior to the 1921 Act, where corporate profits were accumulated for the purpose of preventing the imposition of surtaxes upon the stockholders, a separate tax was laid upon the stockholders. Tariff Act of 1913, Section II A (1), 38 Stat. 166; Revenue Act of 1916, Section 3, 39 Stat. 758; Revenue Act of 1918, Section 220, 40 Stat. 1072.

diate precursor of the undistributed profits tax, provided for the imposition of a graduated surtax upon the income of such corporations. But because of the difficulty of proving the interdicted purpose, this system of taxation presented serious administrative problems and was only partially effective. See H. Rep. No. 1860, 75th Cong., 3d Sess., pp. 2–3. In the Revenue Act of 1936, the provision for the imposition of a surtax on some classes of corporations improperly accumulating surplus was retained and strengthened (Section 102, 49 Stat. 1676), but by Section 14, the principle was extended to all corporations failing to distribute their income, regardless of the presence or absence of any motive of tax avoidance. By this extension, as above stated, Congress sought not only to prevent the avoidance of surtaxes, but, primarily, to provide a fairer distribution of the tax load among all the beneficial owners of business profits, whether derived from unincorporated enterprises or from incorporated businesses, and whether distributed or retained.

There can be no substantial doubt as to the constitutionality of this method of corporate income taxation, nor as to the validity of the classification of income as distributed or undistributed, which is its fundamental requisite. In *Helvering* v. *National Grocery Co.*, 304 U. S. 282, this Court upheld Section 104 of the Revenue Act of 1932 (47 Stat. 195) which, like Section 102 of the 1934 and

1936 Acts, put into a separate class corporations which were formed, or availed of, for the purpose of accumulating income and thereby preventing the imposition of surtaxes on their stockholders. The decision is closely in point, for the creation of a separate classification plainly does not depend for its validity on the existence of a tax evasion motive. Congress may, in its discretion, make any classification which is reasonably designed to afford an equitable distribution of the tax burden or which has reasonable relation to a legitimate end of governmental action. Cf. *Welch* v. *Henry,* 305 U. S. 134; *Watson* v. *State Comptroller,* 254 U. S. 122. The classification here under consideration, which is based on the theory that the corporate profits of a nondistributing corporation have not borne the same tax burden as the profits of a distributing corporation or those of a partnership, clearly meets this test.

2. Since Congress could validly distinguish for tax purposes between corporations distributing and those retaining their net earnings, the tax would clearly be valid if no deductions whatever were granted to corporations under either contractual or legal restraints against the payment of dividends. There remains, therefore, only the question whether the allowance of a credit to nondistributing corporations which are under certain types of contractual restraint against the payment of dividends unlawfully discriminates against corpora-

tions, like petitioner, which are under other types of restraint.

The answer to this question is not in doubt. The allowance of deductions and credits is a matter of legislative grace. *Helvering* v. *Inter-Mountain Life Insurance Co.*, 294 U. S. 686; *Helvering* v. *Ind. Life Ins. Co.*, 292 U. S. 371; *New Colonial Ice Co.* v. *Helvering*, 292 U. S. 435; *White* v. *United States*, 305 U. S. 281; *Deputy* v. *duPont*, 308 U. S. 488. This being so, it is difficult to conceive of any state of facts in which it could successfully be maintained that in granting one deduction and failing to grant another Congress had violated the due process clause because of arbitrary classification. Each time the argument has been made it has been rejected. *Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S. 1; *Anderson* v. *Forty-two Broadway Co.*, 239 U. S. 69; *Denman* v. *Slayton*, 282 U. S. 514; cf. *Welch* v. *Henry*, 305 U. S. 134.

But even if a denial of one deduction or credit and the allowance of another might in some instances result in a denial of due process, yet in this case there was clearly a rational basis for the distinction which Congress drew. It is, in the normal case, a comparatively easy matter for the Bureau of Internal Revenue to ascertain whether a corporation has executed a written contract which expressly prohibits it from paying dividends. But, as we have suggested above, it would impose an intolerable administrative burden on the Bureau

if it were required to determine whether a corporation was prevented from distributing its earnings by virtue of state law. That would involve not only examination of the statutes of the various states and of the decisions construing them, but also an analysis of the entire financial history of each corporation claiming the credit. See Note (1936) 83 U. of Pa. L. Rev. 91–92. The discussion in the succeeding section of this brief of whether the taxpayer in this case was prohibited by North Dakota law from distributing its earnings furnishes a striking illustration of the difficulties involved.

It is no answer for petitioner to suggest (Br. 43–44) that the same difficulties might be encountered had the corporation expressly written into its stock certificates the provisions of state law. It is a matter of common knowledge that the provisions of state regulatory statutes are not normally written into stock certificates and Congress must be presumed to have legislated with this fact in mind. In the usual case of a contractual restraint no difficulties of interpretation are presented and no analysis of the financial situation of the corporation is required in order to determine whether the restraint is operative. The fact that in certain unusual cases which may be conceived of, the Bureau might have the same difficulty in determining whether a corporation was under a contractual restraint as it would normally have in determining whether the corporation was under a statutory

restraint, does not make unreasonable the distinction drawn by Congress between these two situations.

This Court has recognized that the income tax laws do not profess to embody perfect economic theory (*Helvering* v. *Midland Mutual Life Ins. Co.*, 300 U. S. 216) and that they must sometimes yield to the exigencies of administration. See *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359; *Woolford Realty Co.* v. *Rose*, 286 U. S. 319. Pragmatic reasons of administrative convenience, such as those here involved, are alone sufficient justification for the difference between the treatment of corporations under express contractual restraint against the payment of dividends and corporations under a similar statutory restraint. *Carmichael* v. *Southern Coal Co.*, 301 U. S. 495; *Steward Machine Co.* v. *Davis*, 301 U. S. 548.

It has been repeatedly held that a wide discretion must be conceded to the legislative power in the matter of classification. *Flint* v. *Stone Tracy Co.*, 220 U. S. 107; *Tax Commissioners* v. *Jackson*, 283 U. S. 527; *Magoun* v. *Illinois Trust & Savings Bank*, 170 U S. 283. The differences between the class which is taxed and that which is not need not be great; the classification will be upheld if any state of facts can reasonably be conceived to sustain it. *Tax Commissioners* v. *Jackson, supra; Rast* v. *Van Deman & Lewis*, 240 U. S. 342; *Metropolitan Casualty Ins. Co.* v. *Brownell*, 294 U. S. 580; *Carmichael* v. *Southern Coal Co.*,

supra; Madden v. *Kentucky,* 309 U. S. 83. Here the reason for the difference in treatment of statutory restraints and of express contractual restraints is both apparent and cogent; under established authorities it precludes successful attack under the Fifth Amendment.[16]

III

PETITIONER HAS NOT SUSTAINED THE BURDEN OF PROVING THAT IT WAS PROHIBITED BY NORTH DAKOTA LAW FROM DISTRIBUTING ITS 1936 EARNINGS AS DIVIDENDS

For purposes of the discussion under Points I and II, we have assumed, *arguendo,* that the North Dakota statutes prohibited petitioner's directors from distributing as dividends any portion of the company's adjusted net income for 1936. However, should the Court reject the contentions advanced under these points, further inquiry would be required as to whether petitioner has sustained the burden of proving that it was in fact prohibited by state law from distributing all or any part of its net earnings. In our view, this burden has not been met.[17]

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[16] Petitioner cites *Prudential Tobacco Co.* v. *Commissioner,* 42 B. T. A. No. 80, as indicating that the Board of Tax Appeals entertains doubts as to the constitutional issue here presented (Br. pp. 13, 45). The doubts there expressed by the Board relate only to the validity of making the undistributed profits tax retroactive to a short period ending before the Act was approved.

[17] Neither the Board nor the court below found it necessary to pass upon this point, although it was presented to both.

Petitioner's net income for 1936 was $13,450.76 and its adjusted net income was $12,032.72. It was stipulated before the Board that as of January 1, 1936, petitioner had a deficit of at least $21,251.40 (R. 12), but that the records prior to January 1, 1929, were not susceptible of analysis to show definitely whether this deficit occurred from operating losses or capital distributions in excess of earnings or was effected by other adjustments (R. 12). It was further stipulated that no dividend distributions had been made by the petitioner since March 1930, when $9,672 was distributed from then existing surplus (R. 12).

Section 4543 of the North Dakota Laws provides as follows:

> *Dividends only from profits; limitations of indebtedness; exceptions.*—The directors of corporations must not make dividends except from the surplus profits arising from the business thereof; nor must they divide, withdraw or pay to the stockholders, or any of them, any part of the capital stock, nor must they create debts beyond the subscribed capital stock, or reduce or increase the capital stock, except as specially provided by law; * * *.

The question which arises under this statute, as applied to the present case, is whether the stipulation that the corporation had a "deficit" as of January 1, 1936, of a greater amount than its net earnings for 1936 constitutes a showing that the

corporation had no "surplus profits" from which dividends could be paid during that year.[18]

There are no North Dakota decisions which illuminate the meaning of the statutory phrase "surplus profits".[19] Several decisions of other

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[18] It seems clear that a distribution of the petitioner's net income for 1936 would not have constituted a division of capital stock between the stockholders within the meaning of Section 4543. The deficit already existed and would not have been increased or diminished by such a distribution.

[19] In *Lark Equity Exchange* v. *Jones*, 42 N. D. 145, the corporation sued a stockholder to recover dividends alleged to have been paid while there was a deficit. The complaint alleged that on the basis of a financial statement prepared by the manager the directors had declared a dividend; that the statement was erroneous; that the corporation in fact had no profits; that after discovering the error the directors rescinded the resolution declaring the dividend and ordered the money paid back; and that the defendant, who was one of the stockholders, had refused to return the amount received. Recovery was denied on the ground that the evidence failed to disclose the financial condition of the corporation at the time the dividend was declared.

In *Ulness* v. *Dunnell*, 61 N. D. 95, a trustee in bankruptcy sued the stockholders of a corporation to recover dividends the payment of which had rendered the corporation insolvent. The facts disclosed that the corporation's assets consisted chiefly of patents which it had sold to a Canadian corporation and that the distribution had been made from the proceeds of the sale. The distribution left the corporation with debts of $15,000 and assets of only $500. The court stated that under North Dakota statutes dividends could not be paid except out of profits of the corporation and that the stockholders had no right to retain dividends paid out of the capital stock of an insolvent corporation. It implied that recovery might have been denied if the corporation had been solvent and the stockholders had received the dividend in good faith.

courts, however, indicate the view that the phrase should be construed as meaning an excess of gains over expenditures; under definitions of this character, it is arguable that distributions can be made from current net earnings even though a capital deficit exists. *Southern Cal. Home Builders* v. *Young,* 45 Cal. App. 679; *Excelsior Water & Mining Co.* v. *Pierce,* 90 Cal. 131; cf. *Goodnow* v. *American Writing Paper Co.,* 73 N. J. Eq. 692; *Borg* v. *International Silver Co.,* 11 F. (2d) 147 (C. C. A. 2d).[20] If the North Dakota statute be thus interpreted, it is apparent that petitioner was under no legal restraint against the distribution of its 1936 earnings.

It is true, however, that the great weight of authority is to the effect that a statutory prohibition against the payment of dividends except from "surplus," "surplus profits," or "net profits" prevents the payment of dividends from current earnings so long as a capital deficit exists. See Ballantine and Hills, *Corporate Capital and Restrictions on Dividends Under Modern Corporation Laws* (1935) 23 Cal. L. Rev. 229, 238, *et seq;*

[20] The English "Companies Acts" have been construed as not requiring that a capital deficit be made up before dividends may be paid from annual profits. *Lee* v. *Neuchatel Asphalte Co.* [1889], 41 Ch. 1; *Ammonia Soda Co.* v. *Chamberlin* [1918], 1 Ch. 266; 9 B. R. C. 819. The English cases are discussed in "Theory of Anglo-American Dividend Law", by Weiner, 28 Col. L. Rev. 1046; in 55 A. L. R. 8, 20–22; and in "Corporate Capital and Restrictions Upon Dividends under Modern Corporation Laws", by Ballantine and Hills, 23 Cal. L. Rev. 229, 252–255 (1935).

Wiener, *Theory of Anglo-American Dividend Law* (1929) 29 Col. L. Rev. 461, 462 *et seq.* In the states where this rule prevails, the term "surplus," "surplus profits," or "net profits" have been interpreted as meaning the amount by which the present value of a corporation's assets exceeds its liabilities, including capital stock, or as the amount of accumulated profit above expenses and past operating losses. See, e. g., *Williams* v. *Western Union Telegraph Co.*, 93 N. Y. 162; *Russell* v. *Bristol*, 49 Conn. 251; *Crawford* v. *Roney*, 130 Ga. 515; *Coleman* v. *Booth*, 268 Mo. 64; *Splittgerber Bros.* v. *Skinner Packing Co.*, 119 Neb. 259; *Park* v. *Grant Locomotive Works*, 40 N. J. Eq. 114, affirmed, 45 N. J. Eq. 244; *Branch* v. *Kaiser*, 291 Pa. 543; Fletcher, *Cyclopedia of Corporations* (Permanent Ed.) Vol. 11, Sec. 5335; Thompson, *Corporations* (3rd Ed.) Vol 7, Secs. 5292, 5293.

Petitioner has not proved that it was prohibited from paying dividends in 1936 under this test. The only evidence upon which it can rely is (1) the stipulated fact that it had a "deficit" of at least $21,251.40 on January 1, 1936 (R. 12); and (2) its balance sheet, showing a deficit on that date of $22,876.40 (R. 7). It is clear that neither the stipulation, which was based on the book figure,[21] nor

[21] The discrepancy between the stipulated "deficit" of $21,251.40 and the balance sheet "deficit" of $22,876.40 arises from the fact that an audit of the books for 1935 made by a firm of certified public accountants resulted in a reduction of $1,625 in the value at which treasury stock was carried on the books of the company (R. 12).

the book figure itself, constitutes proof that the value of the corporation's assets was less than the amount of its liabilities, including capital stock. There is no showing whatever in the record that the book value placed upon the assets represented actual value, there is no showing of how the book value was computed, and there is no showing of what the actual value of the assets was. There is also no showing of how the amount taken for depreciation, which was more than 33⅓% of the book value of the depreciable assets (R. 7), was arrived at. Clearly this Court cannot assume that petitioner had no surplus profits (construing that term to mean the excess of the value of its assets over the sum of its liabilities, including legal capital) simply because its books showed a deficit.

Nor can petitioner show that it had no accumulated profits above expenses and past operating losses. There is no proof whatever of the net earnings or losses of the company for any year prior to 1936, and it is stipulated that the records of the company prior to January 1, 1929, are not susceptible of analysis to show definitely whether the "deficit" as of January 1, 1936, occurred from operating losses or capital distributions in excess of earnings or was effected by other adjustments.[22]

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[22] While it is true that the stipulation recites that petitioner had a surplus in 1930 and that it has distributed no dividends since 1930, it is not at all clear whether the stipu-

Consequently, petitioner did not and could not establish that it had no accumulated profits in 1936 from which it could have distributed dividends.

There can be no question that the burden of proof was upon petitioner to show that it was prohibited by state law from paying out dividends in 1936. See *Helvering* v. *Leonard*, 310 U. S. 80, 86; *Helvering* v. *Fitch*, 309 U. S. 149. Petitioner having failed to furnish the requisite proof, neither the Commissioner nor the courts are called upon to conjecture as to what the actual situation in 1936 may have been.

CONCLUSION

The decision of the court below should be affirmed on the ground that the North Dakota statute prohibiting dividends except from surplus profits is not a provision of a written contract executed by the petitioner within the meaning of Section 26 (c) (1) and that the statute, so construed, is constitutional. But if the Court should hold otherwise, the decision of the court below should be affirmed on the ground that the petitioner has not sustained the burden of proving that the distribu-

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lation refers to accumulated profits or to the excess of the value of the company's assets over its liabilities, including capital stock, and, if the latter, whether the assets were taken at book value or at actual value. Petitioner's balance sheet for 1930 was not introduced in evidence and no proof was offered as to the financial situation of the company at that time.

tion of its adjusted net income for 1936 would have constituted a violation of state law.

Respectfully submitted.

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SEPTEMBER 1940.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

* * * * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

17 per centum of the portion of the undistributed net income which is in excess of

20 per centum and not in excess of 40 per centum of the adjusted net income.

22 per centum of the portion of the undistributed net income which is in excess of 40 per centum and not in excess of 60 per centum of the adjusted net income.

27 per centum of the portion of the undistributed net income which is in excess of 60 per centum of the adjusted net income.

(c) *Adjusted Net Income Less Than $50,000.*—

(1) *Specific Credit.*—If the adjusted net income is less than $50,000, there shall be allowed a specific credit equal to the portion of the undistributed net income which is in excess of 10 per centum of the adjusted net income and not in excess of $5,000, such credit to be applied as provided in paragraph (2).

(2) *Application of Specific Credit.*—If the corporation is entitled to a specific credit, the tax shall be equal to the sum of the following:

(A) A tax computed under subsection (b) upon the amount of the undistributed net income reduced by the amount of the specific credit, plus

(B) 7 per centum of the amount of the specific credit.

* * * * *

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(c) *Contracts Restricting Payment of Dividends.*—

(1) *Prohibition on Payment of Dividends.*—An amount equal to the excess of

the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) *Disposition of Profits of Taxable Year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

(3) *Double Credit Not Allowed.*—If both paragraph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the

same, only one of such paragraphs shall be applied.

* * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made

* * * * *

[U. S. C. Supp. V, Title 26, Sec. 115.]

North Dakota Compiled Laws—Supplement—(Annotated), 1913–1925:

SEC. 4543. *Dividends only from profits; limitations of indebtedness; exceptions.*—The directors of corporations must not make dividends except from the surplus profits arising from the business thereof; nor must they divide, withdraw or pay to the stockholders, or any of them, any part of the capital stock, nor must they create debts beyond the subscribed capital stock, or reduce or increase the capital stock, except as specially provided by law; provided, however, that the above limitation as to the creation of debts shall not apply to the policy risks of insurance companies on which no loss has oc-

curred, or the notes, bonds or debentures of any loan or trust company, or public utility, company or corporation, organized under the provisions of this chapter, when payment of such notes, bonds or debentures shall be secured by the actual transfer of real estate by trust deed or mortgage for the payment of such notes, bonds or debentures, which said real estate so transferred shall be of twice the value of the par value of such notes, bonds and debentures; provided further that the limitation as to the value of property conveyed by trust deed or mortgage shall not apply to the bonds or debentures of public utility corporations; provided, further, that such limitation shall not apply to any loan or trust company's guarantee of payment after transfer of any note, bond or debenture when the same is secured by trust deed or mortgage as above stated; provided, further that the above limitation as to the creation of debts shall not apply to certificates and debentures issued by investment companies for the creation of an investment fund where the holder of such certificates or debentures shall by the terms of the same, participate in the earnings of such investment fund. [Laws 1925, ch. 109, § 1.]

SEC. 4543a. *To what corporations applicable.*—The provisions of this act shall apply to corporations heretofore and hereafter organized. [Laws 1925, ch. 109, § 2.]

SEC. 4544. *Penalty for violation of statute.*—For a violation of the provisions of the last section [§ 4543] the directors under whose administration the same may have happened, except those who may have caused their dissent therefrom to be entered at large on the minutes of the directors at the time,

or were not present when the same did happen, are in their individual and private capacity, jointly and severally liable to the corporation, and to the creditors thereof, in the event of its dissolution, to the full amount of the capital stock so divided, withdrawn, paid out, or reduced, or debt contracted. There may, however, be a division and distribution of the capital stock of any corporation which remained after the payment of all its debts, upon its dissolution or the expiration of its terms of existence. No action or proceeding to enforce or recover any penalty, forfeiture or liability hereunder shall be commenced more than six months after the aggrieved party shall have had actual notice of the violation of the preceding section [§ 4543]. [Laws 1919, ch. 100, § 1.]

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 26–2. *Credit in connection with contracts restricting payment of dividends.*— (a) The credit provided in section 26 (c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c). The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit

the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

If a corporation is restricted with respect to the payment of dividends by two or more contract provisions coming within section 26 (c) (1), only the largest of the credits computed with respect to each of such provisions, and not their sum, shall be allowable under section 26 (c) (1) and, for such purpose, if two or more credits are equal in amount, only one shall be taken into account. However, section 26 (c) (3) provides that if both section 26 (c) (1) and section 26 (c) (2) apply, only the one of such paragraphs which allows the greater credit shall be applied, and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

(b) *Prohibition on payment of dividends.*—The credit provided in section 26 (c) (1) is allowable only with respect to a written contract executed by the corporation prior to May 1, 1936, which expressly deals with the payment of dividends and operates as a legal restriction upon the corporation as to the amounts which it can distribute within the taxable year as dividends. If an amount can be distributed within the taxable year as a dividend—

(1) in one form (as, for example, in stock or bonds of the corporation) without violating the provisions of a contract, but cannot be distributed within the taxable year as a

dividend in another form (as, for example, in cash) without violating such provisions, or

(2) at one time (as, for example, during the last half of the taxable year) without violating the provisions of a contract, but cannot be distributed as a dividend at another time within the taxable year (as, for example, during the first half of the taxable year) without violating such provisions—

then the amount is one which, under section 26 (c) (1) can be distributed within the taxable year as a dividend without violating such provisions.

The credit provided in section 26 (c) (1) is equal to the excess of the adjusted net income, as defined in section 14 (a), over the aggregate of the amounts which can be distributed within the taxable year without violating the provisions of such contract. The requirement that the provisions of the contract expressly deal with the payment of dividends is not met in case (1) a corporation is merely required to set aside periodically a sum to retire its bonds, or (2) the contract merely provides that while its bonds are outstanding the current assets shall not be reduced below a specified amount.

The computation of the credit allowable under section 26 (c) (1) may be illustrated by the following examples:

* * * * *

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In the Supreme Court of the United States

OCTOBER TERM, 1939.

No. 584 8

CRANE-JOHNSON COMPANY,
a Corporation of North Dakota,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

MOTION FOR LEAVE TO FILE BRIEF AS AMICI CURIAE.

H. H. HOPPE,
Second National Building,
Warren, Ohio,
Attorney for Amici Curiae.

HOPPE, LEA, DAY & FORD,
Second National Building,
Warren, Ohio,
Of Counsel.

THE GATES LEGAL PUBLISHING CO., CLEVELAND, OHIO

In the Supreme Court of the United States

OCTOBER TERM, 1939.

No. 584.

CRANE-JOHNSON COMPANY,
a Corporation of North Dakota,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

MOTION FOR LEAVE TO FILE BRIEF AS AMICI CURIAE.

Now come Warren Telephone Company and The Peerless Electric Company, Ohio corporations, by their counsel, and respectfully move the Court for leave to file a brief as amici curiae herein, and for cause say:

1. Notwithstanding the deficit in capital account of Warren Telephone Company, respondent has assessed a tax against Warren Telephone Company under Section 14 of the Revenue Act of 1936, and has refused to give Warren Telephone Company a credit as provided for in Section 26(c)(1) of the Revenue Act of 1936 and the validity of such assessment is now pending before the Board of Tax Appeals, Docket No. 98,115.

2. The respondent has proposed a similar assessment of tax against The Peerless Electric Company for its fiscal year ending November 30, 1937, which proposed assessment has been protested and is now pending on such protest in the office of the Internal Revenue Agent in Charge at Cleveland, Ohio.

3. Petitioner, Crane-Johnson Company, by its counsel, John E. Hughes, has consented that Warren Telephone Company and The Peerless Electric Company, by their counsel, may file a brief herein as amici curiae, as is shown by the letter of John E. Hughes under date of December 14, 1939, hereto attached.

4. The Honorable Robert H. Jackson, Solicitor General of the United States, counsel for the respondent, has consented that Warren Telephone Company and The Peerless Electric Company, by their counsel, may file a brief herein as amici curiae, provided a copy of such brief is in his hands by December 27, 1939, as is evidenced by his letter of December 19, 1939, and the exchange of telegrams under date of December 21, 1939, hereto attached.

5. A typewritten copy of this motion and the brief as amici curiae were mailed to the Honorable Robert H. Jackson, Solicitor General of the United States, on December 23, 1939, followed by printed copies thereof mailed December 26, 1939.

Respectfully submitted,

H. H. HOPPE,
Second National Building,
Warren, Ohio,
Attorney for Amici Curiae.

HOPPE, LEA, DAY & FORD,
Second National Building,
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Of Counsel.

Evening Star Bld'g.
Washington, D. C.

Telephone
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Law Offices
JOHN E. HUGHES
First National Bank Building
Chicago

December 14, 1939

Henry H. Hoppe, Esq.,
Second National Building,
Warren, Ohio

In re: Crane-Johnson Company vs. Commissioner,
No. 584 Supreme Court

Dear Mr. Hoppe:

I hereby consent that you may file a brief Amicus Curiae in the above-entitled case.

Faithfully yours,

JEH:FH

JOHN E. HUGHES.

(Department of Justice Seal)

OFFICE OF THE SOLICITOR GENERAL
Washington, D. C.

December 19, 1939.

Mr. H. H. Hoppe,
Hoppe, Lea, Day & Ford,
Second National Building,
Warren, Ohio.

Re: No. 584. Crane-Johnson Co. v. Commissioner of Internal Revenue

Dear Sir:

In reply to your letter of December 16, we have no objection to the filing of an *amicus curiae* brief provided you have a draft of the brief here by December 22. Our

brief in opposition to the petition is due for filing January 2, and we would like to have a draft of your brief here before the Government's brief is printed.

Yours very truly,

ROBERT H. JACKSON,
Solicitor General.

WESTERN UNION

Telegram X

December 21, 1939.

To Robert H. Jackson, Solicitor General
Street and No. .....
Place Washington, D. C.

RE CRANE-JOHNSON CASE YOUR LETTER NINETEENTH JUST RECEIVED IMPOSSIBLE TO FILE BRIEF BY TOMORROW COULD GET BRIEF TO YOU BY TWENTY-SEVENTH PLEASE WIRE

H. H. HOPPE

WESTERN UNION

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H H HOPPE—
SECOND NATIONAL BLDG

RE CRANE JOHNSON CASE. SATISFACTORY IF BRIEF RECEIVED BY 27TH—

ROBERT H JACKSON SOLICITOR GENERAL.

27.

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In the Supreme Court of the United States

OCTOBER TERM, 1939.

No. [redacted] 8

CRANE-JOHNSON COMPANY,
a corporation of North Dakota,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF ON BEHALF OF WARREN TELEPHONE COMPANY AND PEERLESS ELECTRIC COMPANY, AMICI CURIAE.

H. H. HOPPE,
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Warren, Ohio,
Counsel for Amici Curiae.

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Warren, Ohio,
Of Counsel.

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In the Supreme Court of the United States

OCTOBER TERM, 1939.

No. 584.

CRANE-JOHNSON COMPANY,
a corporation of North Dakota,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Defendant.

BRIEF ON BEHALF OF WARREN TELEPHONE COMPANY AND PEERLESS ELECTRIC COMPANY, AMICI CURIAE.

STATEMENT.

Warren Telephone Company, an Ohio corporation, was incorporated in 1926, but did not commence business until July 1, 1928. As of December 31, 1935 Warren Telephone Company had a deficit in capital account of $47,131.49. Its income for the year 1936 was $29,028.97, the normal tax upon which was $3,413.77. Notwithstanding the fact that the income of Warren Telephone Company for the year 1936 was insufficient to make up the deficit in capital account, the Commissioner of Internal Revenue has assessed a surtax against the Warren Telephone Company for its failure to distribute its earnings in the year 1936, claiming the right so to do by virtue of the provisions of Sections 14 and 26(c)(1) of the Revenue Act of 1936. Such additional assessment is in the amount of $5,251.12. From such assessment an appeal has been filed with the Board of Tax Appeals and the cause is now there pending, Docket No. 98,115.

The Peerless Electric Company, an Ohio corporation, was incorporated in 1929. As of the end of its fiscal year November 30, 1936 it had a deficit in capital account of $59,751.84. Its income for the fiscal year ending November 30, 1937 was $41,370.25, the normal tax upon which is $5,039.72. Notwithstanding the fact that the income of Peerless Electric Company for the fiscal year ending November 30, 1937 was insufficient to make up the deficit in capital account, the Commissioner of Internal Revenue is proposing to assess a surtax against Peerless Electric Company for its failure to distribute its earnings in the fiscal year 1937, claiming the right so to do by virtue of the provisions of Sections 14 and 26(c)(1) of the Revenue Act of 1936. Such proposed assessment is in the amount of $7,174.37. A protest to such proposed assessment has been filed and the matter is now pending in the office of the Internal Revenue Agent in Charge at Cleveland, Ohio.

In each of these tax years, the statutes of the State of Ohio permitted a corporation to declare dividends only out of the excess of its assets over liabilities including stated capital. (See Section 8623-38 of the General Code of Ohio set forth in the appendix hereof, page 9.)

The directors of a corporation who declare dividends otherwise than as permitted by Section 8623-38 of the General Code, render themselves personally liable to the corporation for the amount of such dividends, and every shareholder who receives such dividend, knowing it to be paid in violation of Section 8623-38, renders himself liable to the corporation for the amount thereof. (See Section 8623-123b of the General Code of Ohio set forth in the appendix hereof, page 11.)

Section 26(c)(1) of the Revenue Act of 1936 permits a corporation, in determining the amount of its adjusted net income subject to surtax, to deduct an amount equal to the amounts which it could not distribute during the

taxable year as dividends "without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends."

POSITION OF AMICI CURIAE.

The position of the Amici Curiae is that:

(1) The statutes of the State of Ohio which prohibit the payment of dividends are written provisions of corporate charters,

(2) Corporate charters are written contracts between the corporations and the State of Ohio,

(3) The statutes of the state which are written provisions of such contract not only expressly deal with the payment of dividends, but, under the circumstances, absolutely prohibited the payment thereof, and

(4) As neither Warren Telephone Company nor The Peerless Electric Company could have distributed any part of their income in the years in question without violating the statutes of the State, which are written provisions of its charter contract with the State, they are not subject to the surtax which in the case of Warren Telephone Company has been assessed, and in the case of The Peerless Electric Company, is proposed to be assessed.

BRIEF.

It is idle to cite authorities in support of the statement that a corporate charter is a contract. This principle of law was recognized by the United States Circuit Court of Appeals in its decision in the case at bar, but for some reason and without citing any authority therefor, it stated that the charter was a contract "for some purposes." (105 F. 2nd 740, 743.) We know of no authorities which hold that a corporate charter is a contract only "for some purposes." We have been able to find no authority which for

any reason puts any limitations upon the rule that a corporate charter is a contract.

In the course of its opinion the United States Circuit Court of Appeals said (105 F. 2nd 740, 743):

> "Here, the Articles of Incorporation and such certificate as may have issued on the organization of the corporation contain no provision restricting dividend payments. It is necessary, therefore, to look to the statutes of North Dakota for the restriction, and to determine whether the state law of North Dakota is a written contract executed by the corporation."

What the court undoubtedly meant by this statement is that, ignoring all other matters, there is no provision to be found within the four corners of the charter that restricts dividend payments. That this is what the court meant is shown by its further statement:

> "These statutes, we think, do not establish a contract executed by the corporation expressly dealing with the payment of dividends. If there is such a contract it is not an express one but is implied."

Section 26(c)(1) of the Revenue Act of 1936 does not require the provision that restricts dividend payments to be an "express" provision. It merely requires that the provision (without saying whether it should be express or implied or incorporated by reference) must "expressly deal" with the payment of dividends. The word "expressly" does not modify the word "provision." It modifies the word "deals."

It is not contended that the statutes are a written contract executed by the corporation. The contention is that the State has by statute provided for the transaction of business in corporate form. Those who desire to take advantage thereof voluntarily file a charter with the State, and the preamble to all such charters reads in substance:

> "We, the undersigned, desiring to form a corporation for profit under the general corporation laws of the State of ..... do hereby certify"

When such charter is accepted by the State a contract arises and the laws of the State are as much a part of it as is the provision of the charter which states, "The name of the corporation shall be XYZ Corporation."

Thus the laws of the State are expressly a part of the charter and we do not have to resort to the principles of inclusion by implication. Further, and even though we did have to resort to such principles, there is nothing to be found in Section 26(c)(1) which forbids the written provision expressly dealing with the payment of dividends to be incorporated in a written contract by implication only. Section 26(c)(1) requires

> (1) a written contract executed prior to May 1, 1936;
>
> (2) a provision of such written contract (whether expressly set forth in the contract or incorporated therein by reference is not specified) which expressly deals with the payment of dividends.

Thus, we respectfully submit the Circuit Court of Appeals erred when in the case at bar it said (105 F. 2nd 740, 743):

> "The corporation itself has made no written contract affecting its right to declare dividends."

The Commissioner in Article 26-2 of Regulations 94 says:

> "The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of Section 26(c)."

Here the Commissioner himself recognizes that a corporate charter is a written contract, but takes it upon himself to say that it is not the kind of a written contract Congress had in mind. Yet Congress did not differentiate be-

tween types or kinds of contracts that restrict dividend payments. It provided that any kind of written contract, a provision of which expressly deals with the payment of dividends, is sufficient to give the credit provided for. Respondent's regulation is so obviously in conflict with the law as to be void and of no effect.

As is pointed out on page 16 of petitioner's brief, the Commissioner has ruled (I. T. 3152, C. B. 1938-1, p. 155) that where a restriction on the payment of dividends is found in the stock certificates, there is a contract restricting the payment of dividends within the meaning of Section 26(c)(1). Certainly the statutes of a state are as binding as any provision that may be found in stock certificates. The Commissioner's position is purely technical and without substance when he in effect says that unless the laws of the state restricting the payment of dividends are copied into stock certificates there can be no credit under Section 26(c)(1), but that such credit can be given where they are set forth in the stock certificate. In the very recent case of *Commissioner v. F. & R. Lazarus and Company* (October Term, Cause No. 56) this Court said:

> "In the field of taxation, administrators of the law and courts are concerned with substance and realities, and formal written documents are not rigidly binding."

In substance and reality, the corporation laws of every state are as much a part of the charter and the stock certificates as though they were copied at length therein.

It is indeed difficult to attribute to Congress an intent to impose a tax upon the failure of a corporation to distribute its earnings by way of dividends where such corporation lacks legal power to distribute its earnings. It is hard to conceive that Congress intended to open an avenue whereby the prosperous, healthy corporations, and those most able to pay, might escape a tax, and at the same time intended that such avenue of escape should be closed to

deficit corporations which, because of legal disability, could not take advantage thereof. If Congress had any such intent, then Section 26(c)(1) levies an arbitrary capricious tax that is unconstitutional and void as violative of the Due Process Clause of the Fifth Amendment. On this point the Circuit Court of Appeals in the case at bar said (105 F. 2nd 740, 744):

> "It is further urged that if construed to tax a corporation because it failed to do an unlawful and criminal act, the statute violates the Fifth Amendment. But no North Dakota statute has been called to our attention which makes it a crime to declare a dividend out of capital. Petitioner is urging the court to decide a question of constitutional law based upon a hypothetical set of facts, which is not permissible."

Certainly there can be no distinction between an unlawful act which imposes a personal liability upon directors and shareholders to refund to the corporation unlawful dividends declared and received, and a criminal act which is punishable by fine payable to the state. Thus no hypothetical set of facts was presented to the Circuit Court of Appeals. The real issue is whether a tax which expressly provides an avenue of escape to some, but which avenue of escape is closed to others laboring under a legal disability, is not a tax that deprives the latter of that Due Process of law which is guaranteed by the Fifth Amendment.

The position of respondent when carefully analyzed becomes an absurdity. Let us assume that the directors of a deficit corporation, in contravention of the State law, pay a dividend to its shareholders in amount equal to its earnings for the taxable year in question. The corporation having so distributed its earnings would, according to respondent, obtain the credit provided for in Section 26 (c)(1). Assume further that in so distributing its earnings the shareholders are advised that the distribution is

in contravention of State Statutes and that they might be required to pay it back. (See *Ulness v. Dunnell*, 61 N. D. 95, 237 N. W. 208.) Assume further that in the same taxable year the shareholders are required to and do pay such dividend back to the corporation. It has escaped the tax. The shareholders report for income tax purposes the receipt of the dividend and likewise report as a loss the return of the dividend perforce of the State statute. The shareholders thus escape a tax on the dividend and the very purpose Congress had in mind of imposing the tax is defeated. Certainly we cannot say that Congress ever intended such a situation to prevail.

We respectfully submit that the decision of the United States Circuit Court of Appeals in the case at bar is erroneous and that the petition for writ of certiorari herein should be granted.

Respectfully submitted,

H. H. HOPPE,

Counsel for Amici Curiae.

HOPPE, LEA, DAY & FORD,
Second National Building,
Warren, Ohio,
Of Counsel.

APPENDIX A.

General Code of Ohio.

G. C. §8623-38. *Dividends.* (a) A corporation may declare dividends payable in cash, shares, or other property out of the excess of the aggregate of its assets less the deductions hereinafter required over the aggregate of its liabilities plus stated capital.

(b) In computing the excess of the assets, deductions shall be made for depletion, depreciation, losses and bad debts. In computing the excess of assets for the purpose of determining the fund available for a dividend payable otherwise than in shares of a corporation deduction shall also be made for the unrealized appreciation, if any, appearing on its books unless the amount thereof shall have been transferred to or included in stated capital. If its articles so provide, a corporation whose business consists substantially of the exploitation of wasting assets, may pay dividends without making deduction for the depletion of such assets resulting from lapse of time or from the consumption or sale of such assets incidental to their exploitation.

(c) No corporation shall declare or pay a dividend in cash or other property when there is reasonable ground for believing that it is unable or, by the payment of the dividend, may be rendered unable to satisfy its obligations and liabilities.

(d) Whenever a dividend is paid, in whole or in part, out of other than earned excess of assets appearing on the books of the corporation at the time of the declaration of such dividend, the shareholders receiving such dividend shall be notified as to its source.

(e) Whenever two or more corporations have heretofore been or shall hereafter be consolidated or merged (pursuant to section 8623-67 of the General Code or by purchase) or whenever a corporation has heretofore been or shall hereafter be reorganized, the earned excess of assets appearing on the books of the constituent or merged corporations or on the books of a corporation prior to

reorganization, may, to the extent that it is not capitalized, be entered as earned excess on the books of the consolidated corporation or on the books of the corporation into which the other or others are merged, or on the books of the reorganized corporation, and thereafter may be treated as earned excess.

A corporation may, by action of its board of directors, apply any part or all of any paid in surplus or any excess of assets however created or arising excepting only surplus arising from revaluation of assets, to the reduction or writing off of any deficit in the account of earned surplus or to the writing off of any particular loss or expense or to the creation of a reserve or reserves for any proper purpose and thereby make available for dividends without notice to the shareholders as to the source of such dividends any earned excess of assets remaining or resulting therefrom or thereafter arising, but in case such action is taken a disclosure thereof shall be made in the next annual statement of the corporation.

Any excess of assets hereafter arising otherwise than from the earnings of a corporation shall be classified according to its derivation and so shown in separate accounts.

(f) Nothing contained in this section shall prevent the directors of a corporation from setting apart out of the excess of assets available for dividends a reserve or reserves for any proper purpose or from abolishing any such reserve.

Whenever the board of directors of a corporation shall be of the opinion that its assets, including patents or good will, have a fair value to the corporation in excess of the amount at which they are carried on its books, and shall determine the amount of such fair value, it may order all or a part of the fair value so determined to be entered on its books and thereby create an excess of assets, which the board of directors may apply to a dividend in shares of the corporation and transfer to stated capital or apply to an increase of stated capital represented by shares without par value.

Any transfer of excess of assets to stated capital shall be deemed to have been made from that part of the excess, if any, which resulted from unrealized appreciation. A

dividend payable in shares without par value may be declared and paid upon the transfer to stated capital of any amount that may be ordered by the board of directors, or, without any change of stated capital, as the board of directors may determine.

No dividend shall be paid to the holders of any class of shares in violation of the rights of the holders of any other class of shares.

G. C. 8623-123b. *Unlawful dividends; penalty.*

The directors of a corporation shall not declare or pay dividends or authorize the withdrawal or distribution of any part of its assets except as provided in this act.

Any shareholder, who shall knowingly accept or receive any dividend or distribution not authorized by this act to be made, shall be liable to the corporation in the amount accepted or received by him with interest at the rate of six per centum per annum until the same shall be repaid.

In case of any wilful or negligent violations of the provisions of this section, the directors, under whose administration the same shall have happened (except those who shall dissent as hereinafter provided), shall be jointly and severally liable to the corporation for the full amount of any such unauthorized dividend or distribution with interest at the rate of six per centum per annum until the same shall be paid.

A director shall not be held to have been negligent within the meaning of this section if he relied and acted in good faith upon the books of a corporation, or upon a balance sheet and profit and loss statement of the corporation and a statement of the assets available for a dividend or distribution represented to him to be correct by the president or the officer of the corporation having charge of or supervision of its accounts, or certified to be correct by a public accountant or firm of public accountants of good reputation, nor shall he be held to have been negligent if in good faith he considered assets at their book values, nor if in any case he followed what he believed in good faith to be sound accounting and business practice.

Any director against whom a claim shall be asserted by or on behalf of a corporation under or pursuant to this

section, or who shall be held liable under or pursuant to this section, shall be entitled to contribution from other directors who are liable, according to the number of such directors, and any and all directors against whom a claim shall be asserted under or pursuant to this section or who shall be held liable, shall have a right of contribution against the shareholders who knowingly accepted or received any dividend or distribution not authorized to be made, and such shareholders shall contribute in proportion to the amounts received by them respectively.

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Supreme Court of the United States

October Term, 1939.

No. [redacted] 8 4

CRANE-JOHNSON COMPANY, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE.

Brief Amici Curiae in Support of Petition for Writ of Certiorari.

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Enid, Oklahoma,
ROBERT L. JUDD,
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(d) The Act in its complained of provisions is unconstitutional and invalid in that it is *arbitrary* and *capricious* so as to amount to confiscation and thereby offend the 5th Amendment by its imposition of a tax upon a corporation which is without income, in a business sense, as where such corporation sustains (in the taxable year) a "non-deductible capital loss" in excess of its "taxable net gain", and in the alternative penalizes a corporation for failing to do the impossible, *viz.*, the declaration and payment of a dividend with nothing on hand out of which to make such payment..... 56

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"Taxation of Undistributed Corporate Profits", by John B. Martin, Jr., in the Michigan Law Review, Vol. 35, November, 1936, No. I, pp. 44, *et seq.;*

(a) Historical background..... 4

(b) Motivation for legislation..... 28

(c) Economic questions raised by surtax on "undistributed corporate profits"..... 30

Taxes by William J. Shultz in the Tax Magazine, Sept., 1939, pp. 516-517 37-40

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Revenue Act of 1936.

Note: The pertinent sections of the Act will be found reprinted in Appendix Exhibit "E," at the following indicated pages thereof.

Section 14—Surtax on Undistributed Profits 104

Section 26—Credits of Corporations 106

Section 27—Corporation Credit for Dividends Paid..... 108

Section 102—Surtax on Corporations Improperly Accumulating Surplus 110

Note: The corresponding law and subject-matter was section 220 under Revenue Acts of 1921, 1924 and 1926, and labeled in each instance "Evasion of Surtax by Incorporation"; which section became 104

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in the Revenue Acts of 1928 and 1932, and there labeled "Accumulation of Surplus to Evade Surtaxes."

This section (104) being the *penalty for evasion* section, under consideration by Mr. Justice Brandeis in *Helvering* v. *National Grocery Company*, 304 U. S. 282, 82 L. ed. 1346, finally became section 102 in the Revenue Act of 1934, and so remained in the Revenue Act of 1936, notwithstanding the adoption of (new) section 14 of the 1936 Revenue Act of which complaint as to constitutionality is herein made.

Section 115—Distributions by Corporations 112

Note: A(2) of this section is *new matter*, as follows:

> "or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year) *without regard* to the amount of the earnings and profits *at* the time the distribution was made.",

highly prejudicial and, we think, unconstitutional in that the definition of *dividends* was extended (over and above all prior definitions) to include distributions out of current earnings without regard to capital impairment or deficits existing at the beginning of the taxable year.

Section 117—Capital Gains and Losses..... 115

Section 351—Surtax on Personal Holding Companies.... 117

Note: This section first appeared in the Revenue Act of 1934, and levies a surtax on the undistributed adjusted net income of personal holding companies independent of any question of *reasonable needs of the business* or *purpose* to evade surtax.

The pertinent portions of above numbered sections of Revenue Act of 1936 will be found cited (or quoted) in the brief proper at following indicated pages:

Section 14 .....14, 67, 68
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Section 27.....50, 51, 52, 53, 54, 67
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There being no provision under either section 102 or section 351 for the exemption from a *second* tax or penalty on earnings which have been taxed in the corporation's hands, as undistributed and which are subsequently distributed, the result may be very heavy double taxation.

UTAH STATUTES.

Section 18-2-16, R. S. of Utah 1933, Powers of Corporations for Pecuniary Profit, Appendix Exhibit "A".. 5
Section 18-2-17, R. S. of Utah 1933, Dividends—Distribution of Capital Forbidden, Appendix Exhibit "A".. 5
Section 103-12-4, R. S. of Utah 1933, Certain Acts Prohibited by Directors, Appendix Exhibit "A"..... 6
Section 103-1-13, R. S. of Utah, Felony—Misdemeanor defined, Appendix Exhibit "A"..... 6
Section 103-1-16, R. S. of Utah 1933, Punishment for Misdemeanor..... 6

WASHINGTON STATUTES.

Remington's Rev. Stat. of the State of Washington, sections 3803-24, Laws of 1933, Session Laws 1933, page 785, Sec. 24, Laws of the State of Washington:

"* * * * * * * *

"In computing the aggregate of the assets of the corporation, the Board of Directors shall determine and make proper allowance for depreciation and depletion sustained, and losses of every character. Deferred assets and prepaid expenses shall be written off, at least an-

nually in proportion to their use as may be determined by the Board of Directors.

"4. *No corporation shall pay dividends.*

"a. In cash or property, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock, after deducting from such aggregate of its assets the amount by which such aggregate was increased by unrealized depreciation in value or revaluation of fixed assets;

"b. In shares of the corporation, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock.

"5. Cash dividends shall not be paid out of surplus due to or arising from,

"a. Any profit on treasury shares before resale; or,

"b. Any unrealized profits due to increase in valuation of inventory before sale; or

"c. The unaccrued portion of unrealized profits on notes, bonds or obligations for the payment of money purchased or acquired at a discount unless such notes, bonds or obligations are readily marketable, in which case they may be taken at their actual market value; or

"d. The unaccrued or unearned portion of any unrealized profit in any form whatever, whether in the form of notes, bonds, obligations for the payment of money, installment sales, credits or otherwise * * *."

Remington's Rev. Stat. of the State of Washington, section 3803-25, Laws of 1933, Session Laws 1933, page 787, Sec. 25, Laws of the State of Washington; penalty for violation last above quoted statutes:

"If any dividend be paid in violation of Section 3803-24, or if any other unlawful distribution, payment or return of assets be made to shareholders,

"1. The directors who knowingly, or without making reasonable inquiry, voted in favor thereof shall be jointly

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and severally liable to the corporation in an amount equal to the amount of the dividends so paid and the distribution, payment or return of assets so made;

"2. Every shareholder who receives any such dividend or any such distribution, payment or return of assets, shall in the following instances be individually liable to the corporation in an amount equal to the amount so received by him:

"a. When no director is liable to the corporation as provided in Subdivision 1 of this section, or

"b. To the extent that the corporation is unable to obtain satisfaction after judgment is recovered against directors upon the liability imposed by Subdivision 1 of this section. * * *"

Appendix Exhibit "C".....pp. 29-30

SUPREME COURT OF THE UNITED STATES.
October Term, 1939.

No. 584

CRANE-JOHNSON COMPANY, *Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE.

BRIEF *AMICI CURIAE* IN SUPPORT OF PETITION FOR WRIT OF *CERTIORARI.*

The undersigned, Harry O. Glasser of Enid, Oklahoma, Robert L. Judd of Salt Lake City, Utah, and W. S. Greathouse of Seattle, Washington, of counsel representing taxpaying corporations in Oklahoma, Utah and Washington, having substantial *undistributed corporate profits* for 1936, respectfully suggest that inasmuch as the constitutional *validity* of the provisions of the Revenue Act of 1936 by which a *tax* is imposed upon such corporations, measured by such *undistributed corporate profits* is now pending in the Courts of the Ninth and Tenth Circuits and will necessarily be involved in and affected by the denial of the petition for *certiorari* prayed for in this cause; it is therefore respectfully urged that this brief *amici curiae* be received and considered in this Honorable Court in support of the petition for *certiorari* presented by petitioner.

ARGUMENT.

That portion of the Revenue Act of 1936, which undertakes to *tax undistributed corporate profits,* is unconstitutional in that it levies

(a) a tax upon the corporation for

> "* * * the stockholder's share in the accumulated profits of the company,"

in violation of the "income definition" of the Supreme Court in *Eisner* v. *Macomber,* 252 U. S. 189; 40 Sup. Ct. Rep. 189; 64 L. ed. 521; 3 Am. Fed. Tax Rep. 3020; and in further violation of the "undistributed profit definition" announced in *Willcuts* v. *Milton Dairy Company,* 275 U. S. 215, 72 Law. ed. 248, 48 Sup. Ct. R. 71.

and

is (in the alternative),

(b) *unconstitutional* in that it is a *penalty on conduct* and *actually* represents an effort to "create a conduit to income" by "increasing the velocity of monetary circulation."

(c) That over and beyond the constitutional invalidity of the law for the reasons above indicated, the law is also invalid and unconstitutional in that it discriminates against corporations (such as the Utah Hotel Company) *with no* "earnings or profits *accumulated* after February 28, 1913," in that such corporations are required to pay the tax *unless a dividend* be made

to stockholders which (under such circumstances) would be *solely* a *return of capital.*

(d) Furthermore, the act in its complained of provisions is unconstitutional and invalid in that it is "arbitrary and capricious so as to amount to confiscation and thereby offend the 5th Amendment," by its imposition of a tax upon a corporation which is without *income* in a business sense, as where such corporation sustains (in the taxable year) a nondeductible capital loss in excess of its "taxable net gain;" or *in the alternative* penalizes a corporation for failing to do the impossible, viz., to make *payment* of a *dividend* with nothing on hand out of which to make such payment.

While it is our purpose to briefly discuss the foregoing pronouncements in the order of their statement, it becomes necessary to first give attention to the historical background of the Act.

HISTORICAL BACKGROUND

An able argument for the theory upon which the statute is written, will be found in an article by John B. Martin, Jr., in the Michigan Law Review, Vol. 35, November, 1936, No. 1, page 44, *et seq.*, and while disclaiming responsibility for the *justification conclusions* of that writer, we desire to avail ourselves of his painstaking effort in preparing a comprehensive historical account of the events leading up to the passage of the law.

We quote (without change in quotation marks) from that portion of Mr. Martin's article as follows:

TAXATION OF UNDISTRIBUTED CORPORATE PROFITS*

John B. Martin, Jr.†

Historical Background

The legislation proposed by President Roosevelt in his message of March 3, 1936, to prevent automatic avoidance of taxation by non-distribution of corporate profits, does not represent a new and previously unheard of system of taxation. It embraces, on the contrary, the gist of proposals made by various individuals and organizations extending back as far as the year 1864 when Congress passed a Revenue Act providing that "gains and profits of all companies, whether incorporated or partnership . . . shall be included in estimating the annual gains, profits, or income of any person entitled to the same, whether divided or otherwise."[1] The Revenue Acts since 1913 have also attempted to deal with the closely related problem of purposeful evasion of surtax by the accumulation of surplus beyond the reasonable needs of the business.[2] In July, 1917, a bill was submitted to the Senate by its Finance Committee[3] containing a section suggested by Senator Jones of New Mexico[4] which levied in addition to normal income tax an additional 15 per cent tax on undistributed net income exempting, however, undistributed profits used for the maintenance of re-

*The material which follows has been limited in scope to a consideration of the new tax on undistributed corporate profits levied by the Revenue Act of 1936. Inevitably some mention has also been required of sections 102 and 351 and their counterparts in previous acts. The attempt has been made to view the principle embodied in the new act from the standpoint both of the lawyer and the economist. The technical accounting problems raised by the act have not been dealt with except as corporate accounting necessarily enters into economic analysis.

†Member of the District of Columbia bar. A. B., Dartmouth; B. Litt., Oxford; J. D., Michigan.—*Ed.*

[1] Act of June 30, 1864, c. 172, 13 Stat. L. 218 at 282, upheld in Collector v. Hubbard, 12 Wall. (79 U. S.) 1 at 17 (1870), and overruled by Pollock v. Farmers' Loan & Trust Co., 158 U. S. 601, 15 S. Ct. 912 (1895). See Eisner v. Macomber, 252 U. S. 189 at 217-219, 40 S. Ct. 189 (1920).

[2] See note 26, infra.

[3] 55 Cong. Rec. 4631, 4646 (1917); H. R. 4280, § 1206 (2).

[4] 61 Cong. Rec. 6842 (1921).

serves required by law and 20 per cent of net income directly engaged in the production or distribution of commodities or in banking. This bill was sent back to the committee and altered. A subsequent amendment proposed a flat 10 per cent tax on the amount of undistributed net income retained,[5] but this was modified to apply only to income not retained for actual employment in the reasonable needs of the business.[6]

The statement has often been made that an ideal method would be to tax corporate income as though it belonged to the stockholder whether divided or not.[7] But the decision in 1920 of the United States Supreme Court in *Eisner* v. *Macomber*[8] seems to make this impossible. A tax on stock dividends was involved in that case. The court expressed itself strongly to the effect that "the stockholder's share in the accumulated profits of the company is capital, not income" and cannot be taxed directly without apportionment until distributed as dividends other than stock dividends.

In addition to the pronouncement of the Supreme Court, the year 1920 was also fruitful in suggestions from several sources. The National Association of Credit Men in January, 1920, sent out from its Committee on Federal Taxation a proposal that the corporate income and excess profit taxes be repealed, that the dividends from current earnings be made subject to the normal tax in the hands of individuals and that a tax be levied on the undistributed net income. This tax was to be a graduated tax, each additional 10 per cent of undistributed net income paying a higher tax.[9] In line with this proposal

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[5] 55 CONG. REC. 6175 (1917).

[6] 40 Stat. L. 300 at 334, c. 63, § 1206 (2) (1917).

[7] Remarks of Senator Jones of New Mexico, 65 CONG. REC. 8012 (1924) and 20 PROC. NAT. TAX ASSN., Report of Committee on Simplification of the Income Tax, p. 108 at 133 (1927).

[8] 252 U. S. 189 at 219, 40 S. Ct. 189 (1920), See Justice Brandeis' dissent at pp. 230-232 favorable to taxing the pro rata share of undistributed profits as income. See Revenue Act of 1916, 39 Stat. L. 756, c. 463, tit. I, part I, § 2(a).

[9] Message from the Committee on Federal Taxes of the National Association of Credit Men (January 1920). See remarks of R. G. Elliott, chairman of this committee, in PROC. NAT. IND. TAX CONF. 64-70 (April, 1920), and of Senator Jones of New Mexico, 61 CONG. REC. 6834, 6841, 6845, 6851 (1921). Note that in the recent House proposal the tax was a percentage of adjusted net income and not of undistributed net income. In the bill as finally passed, the tax is a per cent of undistributed net income, the per cent being determined by the per cent of net income undistributed. In both, however, the ultimate reference is to the amount of net income retained by the corporation.

an amendment was offered by Senator Jones of New Mexico,[10] but it was not finally made part of the Revenue Act.

In March, 1920, Secretary Houston of the United States Treasury suggested to the House Ways and Means Committee that a tax on the annual undistributed profits of corporations would be a desirable change in the tax system.[11] The Secretary recognized that this taxed reinvested profits but pointed out that even if unwise economically it was an accepted principle as to sole traders and partnerships, and therefore should be equally applicable to corporations. He felt that if the tax were moderate it would not result in an uneconomic disbursement of dividends.

During the same year the Second National Industrial Tax Conference considered and rejected the idea of a tax on undistributed income "because that . . . would penalize saving, encourage distribution and put an undesirable pressure on the directors of a corporation to pay excessive dividends."[12] It was suggested that an attempt be made to equalize the tax burden and to tax the undistributed income by increasing the normal income tax and providing for partial abatement of the tax on individual income reinvested. At this same conference the Tax Committee of the National Conference of State Manufacturers' Associations presented a plan differing in that it proposed a progressive tax upon undistributed net income based upon (a) the amount of invested capital, and (b) the ratio of undistributed net income to invested capital.[13]

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[10] 61 CONG. REC. 6834, 6841 ff. (1921).

[11] This suggestion was included in the ANNUAL REPORT OF THE SECRETARY OF THE TREASURY 39-43 (1920). Both flat and graduated taxes were suggested as alternatives. It was also suggested that if a progressive tax was used the total surtax should never exceed 20 per cent of the undistributed profits.

[12] PROC. SECOND NAT. IND. TAX CONF. 7, 170, 172-174 (Oct., 1920).

[13] In addition it was proposed (1) to attempt no change in the general principle involved under then existing law in taxing individuals (other than stockholders), sole proprietors and partnerships, (2) to withdraw the existing exemption from normal tax on dividends received from corporations, (3) to exempt corporations from any normal income tax. Compare this plan with the House proposal to differentiate between corporations on the basis of the amount of income earned. Roughly, perhaps, the amount of invested capital may be thought to be proportionate to the amount of net income in ordinarily prosperous times. Remarks of J. F. Zoller, PROC. SECOND NAT. IND. TAX CONF. 134-139, 187 (Oct. 1920).

By 1923 Dr. T. S. Adams[14] was saying to the National Tax Association in relation to the discrepancy between taxation of partners and corporations: "In consequence, we have all sorts of proposals to lay additional tax on the undistributed profits of corporations. . . . I do not quarrel with this rejection of the proposal to treat corporations like partnerships. . . ."[15] He continued,

> "We reject an exact solution of this problem . . . because when we face the issue squarely we conclude that it would be inadvisable to put a premium on the complete distribution of corporate profits.[16] We want corporations to save, to reinvest, to plow back their profits into the business. We admit that it would be undesirable to apply the high surtaxes to the saving made by corporations . . . that part of the business income of the country [representing savings] cannot stand surtaxes rising to fifty per cent."[17]

In 1924 an amendment was again offered by Senator Jones and was accepted by the Senate, 43 to 32, which imposed, in addition to a 9 per cent normal tax on corporate income, a graduated tax on undistributed net income beginning at one-half of one per cent of undistributed net income when the undistributed net income was more than 10 but less than 11 per cent of surtax net income. The taxing framework bore a

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[14] Former Chairman of the Advisory Tax Board of the Bureau of Internal Revenue. Dr. Adams' opinion is quoted because there has been considerable controversy as to the position which his long study of tax problems led him to take on the principle of taxation of undistributed corporate earnings. See testimony of G. O. May, S. Hearing on H. R. 12395, 74th Cong., 2d Sess., p. 542 (1936).

[15] 16 Proc. Nat. Tax Assn. 308-309 (1923).

[16] Dr. Adams had changed his earlier position. A U. S. Treasury memorandum entitled, "Treatment of Business Income and of Attempts to Prevent the Escape of Taxes through the Retention of Corporation Earnings," (1936) states that Dr. Adams "as early as 1918 went on record in favor of the taxation of undivided profits at the rates which would apply if such profits were distributed to the shareholders. . . . The same thought was behind his recommendation in 1920 to the Second National Industrial Tax Conference that the corporation income tax be raised from 10% to 16%, and his proposal in substance became a part of the Majority Report of the Conference Board's Tax Committee."

[17] In this same address Dr. Adams suggests a *progressive* tax on spending as the alternative to the principle which he rejects.

marked resemblance to that of the recently adopted act.[18] This amendment was eventually eliminated from the bill in conference.

More recently still the conference of the National Tax Association has fallen in with the suggestion for a tax on undistributed corporate profits.[19] The position was taken that, in view of the practice by which sole traders and partners are taxed on their reinvested income,[20] we ought to return "to the idea that a corporation is merely a conduit through which income passes and that the only recipient who should be taxed is the natural person as stockholder, who enjoys the income earned by the corporation."[21] The Association recommended that the tax be a flat 10 per cent of the amount of net income for the year in excess of dividends paid and that it be considered as a *premium tax* paid by the corporation for its stockholders in exchange for the privilege of retaining the earnings in the business, thereby postponing the normal tax and surtax until a future day.[22] It was pointed out that this "gentle but steady pressure" upon the directors would lead them, as the persons best qualified to judge of the needs of the business, "to pare the surplus down to actual needs and reasonable requirements."[23] The Association takes care to point out that the pressure must be a "gentle" one and the tax "reasonable."

In 1928 the Joint Committee on Internal Revenue Taxation, headed by L. H. Parker, considered the question and, in a

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[18] It is interesting to compare this amendment with the present Revenue Act. See 65 CONG. REC. 8032 (1924); H. R. 6715, 68th Cong., 1st sess. (1924), in Senate pp. 85-93.

1924 AMENDMENT	PRESENT TAX
Surtax Net Income: Net income plus interest received from Federal bonds not exempt from surtaxes plus income from other corporations.	*Adjusted Net Income:* Net income less normal tax less interest received on obligations of the United States.
Undistributed Net Income: Surtax net income less normal tax and cash dividends paid during year.	*Undistributed Net Income:* Adjusted net income (from which the normal tax has been deducted) less credit for dividends paid less credit for contracts restricting dividends.

[19] 20 PROC. NAT. TAX ASSN., Report of Committee on Simplification of the Income Tax, pp. 108-167 (1927).

[20] See §§ 181-183 Revenue Act of 1934, 48 Stat. L. 730. Compare with recommendations of Secretary Houston, note 11, supra.

[21] 20 PROC. NAT. TAX ASSN. 133 (1927).

[22] 20 PROC. NAT. TAX ASSN. 133-134 (1927).

[23] 20 PROC. NAT. TAX ASSN. 136-137 (1927).

report concurred in by the Advisory Committee of which Dr. Adams was a member, rejected an undistributed profits tax. The Committe pointed out,

> "The most obvious objection to such a tax is the burden which it places on legitimate and proper business expansion. As a business expands not only does its plant and property increase but a larger working capital is required and it is desirable that reasonable accumulation of profits necessary for the expansion and stability of corporations should not be unduly burdened."[24]

That the present plan was in the mind of the President prior to his message of March 3, 1936, is indicated from the recommendations made but not elaborated upon on June 19, 1935, in the President's message to Congress. The President then said, "We should likewise discourage unwieldy and unnecessary corporate surpluses."[25]

To complete the historical picture it is necessary to advert to past legislation by which Congress has sought to prevent the accumulation of surpluses and evasion of taxation. The method first employed disregarded the corporate entity and sought to tax the individual for his pro rata share in corporate income, whether distributed or not, as though it had been distributed, where the corporation was formed or availed of for the purpose of evading taxation through accumulation of gains and profits.[26] This approach to the problem was retained until 1921 when a change in principle was made whereby a penalty tax was assessed against the corporation. In the 1934 act this was made applicable where the corporation is formed or employed for the purpose of preventing the imposition of the surtax upon its shareholders or upon those of any other corporation through the device of allowing gains and profits to accumulate instead of being distributed.[27] It should

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[24] REPORT OF JOINT COMMITTEE ON INTERNAL REVENUE TAXATION 54, 70th Cong., 1st Sess. (1927).

[25] 79 CONG. REC. 9713 (1935).

[26] Revenue Act of 1913, § II (A) 2, 38 Stat. L. 166; Revenue Act of 1916, § 3, 39 Stat. L. 758; War Revenue Act of 1917, § 3, 40 Stat. L. 301; Revenue Act of 1918, § 220, 40 Stat. L. 1072.

[27] Revenue Act of 1934, §102, 48 Stat. L. 702. See also § 220 of Revenue Acts of 1921, 1924, 1926, 42 Stat. L. 247, 43 Stat. L. 277, 44 Stat. L. 34; § 104 of Revenue Acts of 1928, 1932, 45 Stat. L. 814, 47 Stat. L. 195. For complete

be noted that the purpose to evade taxation is here of prime importance. Without it no tax is imposed. But the purpose need not be fraudulent. The fact that gains or profits are allowed to accumulate beyond the reasonable needs of the business is made prima facie evidence of purpose to avoid the surtax.[28] This has been interpreted as not preventing ordinary business expansion.[29] Included in reasonable needs of the business are (1) adequate working capital, (2) additions to plant reasonably required, (3) additions to sinking fund for bond retirement.[30] Nor is it unreasonable to take into account in accumulating reserves the hazards of the particular business, its normal rate of expansion unemployment insurance, or employee benefits. It would also seem reasonable to allow accumulation to offset fluctuations in the wage scale and to cover bad accounts receivable. On the contrary, accumulations for the purpose of buying stock and bonds of other corporations with which the business of the purchasing corporation has no obvious relation is unreasonable accumulation.[31]

Two factors are of especial significance in relation to this method of preventing tax avoidance. First, it has been very difficult to enforce because a purpose to avoid the surtax is hard to show either directly or by the prima facie presumption arising from accumulation beyond the reasonable needs of the business. What is reasonable may depend upon dozens of factors, and equally sane men may differ widely on the question as regards any given business. It seems to be generally admitted that the statute has been in many respects a dead letter.[32] Because its penalty is severe, the natural tendency

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discussion of these acts, see 5 PAUL and MERTENS, LAW OF FEDERAL INCOME TAXATION, §§ 48.26-48.35 (1934); Sherman, "Taxation of Corporations Used to Avoid Taxes Upon Stockholders," 13 TAX MAG. 19, 78 (1935); Lang, "Surtaxes on 'Personal Holding Companies' and 'Corporations Improperly Accumulating Surplus'," 13 TAX MAG. 274 (1935).

[28] Revenue Act of 1934, § 102 (b), 48 Stat. L. 702.

[29] Wm. C. DeMille Productions, Inc., 30 B. T. A. 826, 31 B. T. A. 1161 (1934).

[30] TREAS. REG. 86, art. 102-3.

[31] Statement of Assistant General Counsel of Bureau of Internal Revenue, Dec. 13, 1934. See 5 PAUL and MERTENS, LAW OF FEDERAL INCOME TAXATION, Supp., 71-72 (1935).

[32] 65 CONG. REC. 8014 (1924). Senator Jones of New Mexico remarked, "It is admitted by everybody, and the Secretary of the Treasury in his testimony stated that he had not found a single corporation which had violated that provision of the law."

has been to enforce it in extreme cases only.[33] In the last fifteen years not more than ten cases have arisen under this section of the act. The criticism is perhaps justified that this method of dealing with accumulated surplus is "cracking nuts with sledge hammers."[34] Second, it is to be observed that the tendency in enforcing the act has been to avoid encouraging unorthodox business practices. The practice has been to consider every fact which a prudent business man would consider as bearing on the question of reasonableness of accumulation.[35]

The problems of proof involved in section 102 led in 1934 to the enactment of section 351 dealing with personal holding companies. This section defines a personal holding company in terms of (1) sources of income, and (2) stock ownership.[36] It levies a surtax upon the undistributed adjusted net income of such companies independent of any questions of reasonable needs of the business or purpose to avoid surtax.[37] It should be noted that though provision is made for the exemption from tax in the hands of the corporation of dividends paid during the year,[38] there is no provision under either section 102 or section 351 for the exemption from a second tax on earnings which have been taxed in the corporation's hands as undistributed and which are subsequently distributed. This may result in very heavy double taxation. It is conceivable that such a result is justified under section 102, where a purpose to avoid taxes is the basis for the penalty, but it is difficult to justify under section 351 where no such purpose need exist.[39] It is true

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[33] Revenue Act of 1934, § 102 (a), 48 Stat. L. 702, takes as tax 25 per cent of the adjusted net income not in excess of $100,000 plus 35 per cent of that in excess of $100,000, in addition to the normal corporation income tax running as high as 15 per cent in the 1935 act. For an illustration of the possible burden of this tax, see Sherman, "Taxation of Corporations Used to Avoid Taxes Upon Stockholders," 13 TAX MAG. 78 at 81-82 (1935).

[34] 20 PROC. NAT. TAX ASSN. 134 (1927).

[35] Statement of Assistant General Counsel of Bureau of Internal Revenue, Dec. 13, 1934. See 5 PAUL and MERTENS, LAW OF FEDERAL INCOME TAXATION, Supp. 71-72 (1935).

[36] Revenue Act of 1934, § 351 (b) (1), 48 Stat. L. 751.

[37] TREAS. REG. 86, art. 351-1.

[38] This applies to corporations under both sections 102 and 351. See Revenue Act of 1934, § 102 (c) and 351 (b) (2) (C), 48 Stat. L. 702, 751.

[39] See criticism of such a situation by R. G. Elliott, Chairman of Committee on Federal Taxation of National Association of Credit Men. PROC. SECOND NAT. IND. TAX CONF. 125 (Oct. 1920). Also see Sherman, "Taxation of Corporations Used to Avoid Taxes Upon Stockholders," 13 TAX MAG. 78 at 82, 84 (1935).

that both sections allow the stockholder to avoid this double tax by reporting his pro rata share of adjusted net income, if *all* the stockholders in the corporation do likewise. Because the unanimous action of all the stockholders is requisite,[40] this is not a complete solution for the individual stockholder.

It is to be observed that though operating companies may come under the specific definition of section 351 if they have investments, the return on which equals 80 per cent of gross annual income,[41] the section is primarily aimed at holding rather than operating companies.[42] Furthermore, section 102, while applicable to operating companies, has not been enforced against them.[43] These facts have especial meaning in their indication that the economic and legal effects of sections 102 and 351 in their present and earlier forms cannot be regarded as comparable to the effects which may be expected from the Revenue Act of 1936. The former sections in practice have affected only *holding* companies. The surtax on undistributed profits in the Revenue Act of 1936 is in addition to these sections and purports to affect all *operating* companies with certain specified exceptions. The argument that the holding company serves no useful economic purpose cannot be made as to the operating company if it should be found that the new law will operate to the harm of the companies taxed.

While there are in Mr. Martin's article quite a number of digressions from a recitation of a strictly historical background, it was thought best to quote that portion of the article in its entirety, rather than to undertake to delete what might be assumed to be an unimportant part thereof.

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[40] Revenue Act of 1934, § 102 (d), § 351 (d), 48 Stat. L. 702, 752, as amended by Revenue Act of 1935, § 109, 49 Stat. L. 1020. See text, infra, p. 62, regarding an additional obstacle put in the way of such pro rata reporting under the Revenue Act of 1936, § 102 (d) and § 351 (d).

[41] 361 CCH Federal Tax Service 679E-679I.02, assuming, of course, that the requisite stock ownership also exists.

[42] Note 27, supra, Sherman, "Taxation of Corporations Used to Avoid Taxes Upon Stockholders," 13 Tax Mag. 78 (1935).

[43] Sherman, "Taxation of Corporations Used to Avoid Taxes Upon Stockholders," 13 Tax Mag. 78 at 120 (1935). "The effective enforcement of the statute is practically limited to nonoperating companies such as personal holding or investment companies."

Without further comment, we proceed to a consideration of the subdivision of the constitutional question, stated supra (p. 2) as,

(a) that,

> **"That portion of the Revenue Act of 1936 which undertakes to tax undistributed corporate profits is unconstitutional in that it is an effort to tax the corporation for 'the stockholder's share in the accumulated profits of the company'."**

We rest this statement of position upon the authority of *Eisner* v. *Macomber,* supra, *Willcuts* v. *Milton Dairy Company, supra,* and

> *Towne* v. *Eisner,* 245 U. S. 418, 38 Sup. Ct. Rep. 158, 62 L. ed. 372; 3 Amer. Fed. Tax Rep. 2959.

See also:

> *United States* v. *Safety Car Heating Company,* 56 Sup. Ct. Rep. 353, 297 U. S. 88-101, 80 Law. Ed. 500, 16 Amer. Fed. Tax Rep. 1311;

Where Mr. Justice Cardozo (headnote 5) stated:

> "* * * Income within the meaning of the Sixteenth Amendment is the fruit that is born of capital *not* the *potency of fruition.* With few exceptions, if any, it is *income* as the word is known in the common speech of man.
>
> Lynch v. Hornby, 247 U. S. 344, 62 Law ed. 1151, 58 Sup. Ct. Rep. 543.
>
> "* * * When it is *that* it may be taxed, though it was in the making long before."

In an article in the Yale Law Journal, by Homer Hendricks (page 18, Volume 46, November, 1936, Number I), it is said:

"No part of the Revenue Act of 1936 has excited more general interest than that imposing the surtax on undistributed profits of corporations. The tax is *new, untried* and *complicated;* the provisions imposing it *were hastily drawn.*

"One need not here dwell on its importance as a matter of *tax technique* or *social policy.* It is enough to say that under it rates are dependent *on what the corporation does or fails to do* with its income during the taxable year, and that if action *along prescribed lines is not or cannot be taken* the resulting tax may be very large." (Italics supplied.)

At pages 48 to 50 inclusive of the same article, Mr. Hendricks concludes as follows:

"A redefinition of 'income' may be required if this tax is sustained. For the undistributed profits surtax is not imposed on the receipt of income, but on the disposition which a corporation makes of its income. The question here is whether an income tax must necessarily be imposed only with respect to income receipts and not with respect to income disbursements. A tax on spending, generally imposed on all spending and at rates varying according to the spending which Congress desired to encourage or discourage would, runs the argument, not be sustainable as a tax on 'income.' It is argued that a tax may not, unless clearly necessary to prevent evasion of the ordinary tax on incomes, be imposed as a result of the use which a taxpayer makes of the income. When the question reaches the courts, more analysis will be required than has as yet been made in any of the decisions regarding the nature of the income tax and the powers which Congress has with respect thereto. The income tax is in its nature an excise.[110] Heretofore it has been imposed in respect of the receipt of income; whether, if imposed on disbursement or failure to disburse in a specified way, it becomes something other than a tax on income remains to be decided.

The counter argument to the effect that the tax is imposed 'upon net income'[111] although 'measured' by the amount of the

110. Brushaber v. Union Pacific R. R., 240 U. S. 1, 16-17 (1916).
111. See § 14 (b).

undistributed net income[112] appears to have little force. Even if the denomination by Congress of the tax as a 'Surtax on Undistributed Profits'[113] be disregarded, the purpose of Congress was, clearly, to force the distribution of profits, and for all practical purposes the tax is imposed on the undistributed portion of the profits.[114]

It is often contended that the tax is necessary in order to force the distribution of profits to stockholders and thus make effective the surtax on individuals, thereby promoting equality of taxation of income from business, whether derived from corporations, partnerships, or sole proprietorships. It is to be noted, however, that the surtax in question, unlike that imposed by Section 102 (the accumulation of earnings or profits beyond the reasonable needs of the business and with intent to avoid the imposition of the surtax on shareholders) and the surtax imposed by Section 351 (personal holding companies), is directed against the innocent as well as the guilty. It is the common experience of the business world that the amount of 'tax avoidance' which the surtax is professedly designed to prevent is infinitesimal as compared with cases where earnings are retained, not to minimize taxes, but for purposes of expansion, increase of working capital and for other ends which the business world has regarded as legitimate, although it is now said that financing out of earned surplus results in a misdirection of resources, and should be replaced by financing on the open markets. Whether or not critics are right in viewing the American practice of reinvesting surplus as uneconomic, and whether or not the Federal Government has constitutional power to change the business policy of every corporation in the country by virtue of a new tax, are issues immaterial to the question of how far Congress may go in its anxiety to prevent tax avoidance. The cases in which the Supreme Court has given weight to the prevention-of-tax-avoidance argument have involved notorious devices directly affecting the flow of the revenue.[115]

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112. *Cf.* Art. 14-1.

113. See § 14, headline. See also p. 1, *supra.*

114. For the disposition of an analogous contention, see Nichols v. Coolidge, 274 U. S. 531, 540-541 (1927).

115. Thus, amendments to the estate tax provisions taxing certain kinds of tax avoidance transfers have been sustained, Milliken v. United States, 283 U. S. 15 (1931); and provisions having to do with trusts and other trans-

And it must be conceded that there are serious deficiences in the Act as it now stands from the point of view of that arbitrariness of incidence which may be considered violative of due process.[116] The argument of due process would have considerable force, especially if raised in cases involving situations where imposition of the tax is made on a corporation which has no income in the business sense during the year, or where the tax results in very great hardship, even penalizing the corporation for not doing what may be impossible; for example, cases in which the corporation has a non-deductible capital loss in excess of its taxable 'net income,' or where a corporation is unable to meet its debts at maturity if a portion of its earnings and profits be not accumulated for that purpose. Further, the Act contains no provision exempting from the surtax on undistributed profits a corporation which has a surplus deficit and which, therefore, is prohibited by state law from the payment of dividends. But in this case, hardship to the corporate taxpayer can sometimes be avoided by a recapitalization,[117] or by a revaluation of assets or by the reduction or elimination of various kinds of reserves, with corresponding adjustments to the surplus account. If the financial condition of the corporation is serious enough, it might even be put into receivership or bankruptcy.[118]

Other illustrations of the force of this accusation of arbitrariness have been given as the article progressed. In some cases, it is true, where the Act may on casual study seem to operate inequitably, a means may often be found within its terms of avoiding serious hardship.

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actions directly affecting the productiveness and the equality of the burden of the income tax, Taft v. Bowers, 278 U. S. 470 (1929); Corliss v. Bowers, 281 U S. 376 (1930); Reinecke v. Smith, 289 U. S. 172 (1933); Burnet v. Wells, 289 U. S. 670 (1933); DuPont v. Commissioner, 289 U. S. 685 (1933).

116. "That a federal statute passed under the taxing power may be so arbitrary and capricious as to cause it to fall before the due process of law clause of the 5th Amendment is settled." Mr. Justice Sutherland in Heiner v. Donnan, 285 U. S. 312, 326 (1932), citing Nichols v. Coolidge, 274 U. S. 531 (1927), Brushaber v. Union Pacific R. R., 240 U. S. 1 (1916), Tyler v. United States, 281 U. S. 497, 504 (1930).

117. For example, by reducing the par or stated value of the shares, or converting par stock into no par stock (with an appropriate credit in either case to the surplus account), or by having shareholders surrender the necessary number of shares for retirement.

118. See p. 21, *supra*.

Thus, where a corporation has not sufficient cash with which to pay dividends, the corporate taxpayer may pay dividends in obligations [119] or in kind [120] in order to get a dividends-paid credit. The declaration of an optional stock dividend [121] or the payment of a taxable stock dividend [122] is also sufficient. The procedure whereby a cash dividend is paid, and followed by a subscription by the shareholders to additional stock in the corporation may possibly be advised; it was cited with approval as a means of relief by two important Treasury witnesses in the hearings on the Bill.[123] The payment of a cash dividend and the immediate repayment of the same by all the shareholders as a loan to the corporation should perhaps be avoided.[124] Likewise, where the corporation realizes a large gain, for example, on a sale of property, and the proceeds are not in a form which is easily distributable to shareholders, it is possible for the corporation to transfer the desired amount of the proceeds to a newly organized corporation and pay a dividend in shares of the stock of the new corporation."

In *Eisner* v. *Macomber, supra,* Mr. Justice Pitney defined *income* for *income tax purposes* within the Sixteenth Amendment, and what was there said has not since been modified in any particular, nor has there been any improvement (in any other published decision) upon the context of that far-reaching and able opinion.

We quote those portions of that opinion, which we believe to be pertinent; viz.,

> "This case presents the question whether, by virtue of the 16th Amendment, Congress has the power to tax, as income of the stockholder and without apportionment, a stock dividend made lawfully and in

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119. See p. 37, *supra.*

120. See p. 41, *supra.*

121. See p. 35, *supra.*

122. See p. 38, *supra.* There may be serious problems of valuation in all these cases, however.

123. See *Hearings before the Committee on Finance on H. R.* 12395, 74th Cong., 2d Sess. (1936) 30-31, 36, 918.

124. Where the loan is evidenced by obligations, the net effect of the transaction would be that the dividend was paid in that form. As to cases where the accounts of the stockholders are merely credited, see p. 31, *supra.*

good faith against profits accumulated by the corporation since March 1, 1913.

"It arises under the Revenue Act of September 8, 1916 (chap. 463, 39 Stat. at L. 756 et seq., Comp. Stat., sec. 6336a, Fed. Stat. Anno. Supp. 1918, p. 312), which, in our opinion (notwithstanding a contention of the government that will be noticed), plainly evinces the purpose of Congress to tax stock dividends as income.

"The facts, in outline, are as follows:

"On January 1, 1916, the Standard Oil Company of California, a corporation of that state, out of an authorized capital stock of $100,000,000, had shares of stock outstanding, par value $100 each, amounting in round figures to $50,000,000. In addition, it had surplus and undivided profits invested in plant, property, and business, and required for the purposes of the corporation, amounting to about $45,000,000, of which about $20,000,000 had been earned prior to March 1, 1913, the balance thereafter. In January, 1916, in order to readjust the capitalization, the board of directors decided to issue additional shares sufficient to constitute a stock dividend of 50 per cent of the outstanding stock, and to transfer from surplus account to capital stock account an amount equivalent to such issue. Appropriate resolutions were adopted, an amount equivalent to the par value of the proposed new stock was transferred accordingly, and the new stock duly issued against it and divided among the stockholders.

"Defendant in error, being the owner of 2,200 shares of the old stock, received certificates for 1,100 additional shares, of which 18.07 per cent, or 198.77 shares, par value $19,877, were treated as representing surplus earned between March 1, 1913, and January 1, 1916. She was called upon to pay, and did pay under protest, a tax imposed under the Revenue Act of 1916, based upon a supposed income of $19,877 because of the new shares; and an appeal to the commissioner of internal revenue having been disallowed,

she brought action against the collector to recover the tax. *In her complaint she alleged the above facts, and contended that in imposing such a tax the Revenue Act of 1916 violated art. 1, sec. 2, cl. 3, and art. 1, sec. 9, cl. 4, of the Constitution of the United States, requiring direct taxes to be apportioned according to population, and that the stock dividend was not income within the meaning of the 16th Amendment. A general demurrer to the complaint was overruled upon the authority of Towne* v. *Eisner, 245 U. S. 418, 62 L. ed. 372, L.R.A. 1918D 254, 38 Sup. Ct. Rep. 158; and, defendant having failed to plead further, final judgment went against him. To review it, the present writ of error is prosecuted.*

"* * * * * * *

"We are constrained to hold that the judgment of the district court must be affirmed: First, because the question at issue is controlled by Towne v. *Eisner, supra; secondly, because a re-examination of the question, with the additional light thrown upon it by elaborate arguments, has confirmed the view that the underlying ground of that decision is sound, that it disposes of the question here presented, and that other fundamental considerations lead to the same result.*

"In *Towne* v. *Eisner,* the question was whether a stock dividend made in 1914 against surplus earned prior to January 1, 1913, was taxable against the stockholder under the Act of October 3, 1913 (chap. 16, 38 Stat. at L. 114, 166, Comp. Stat., sec. 5291, 2 Fed. Stat. Anno., 2d ed., p. 724), which provided (sec. B, p. 167) that net income should include 'dividends,' and also 'gains or profits and income derived from any source whatever.' Suit having been brought by a stockholder to recover the tax assessed against him by reason of the dividend, the district court sustained a demurrer to the complaint. 242 Fed. 702. The court treated the construction of the act as inseparable from the interpretation of the 16th Amendment; and, having referred to Income Tax Cases (Pollock v.

Farmers' Loan & T. Co.), 158 U. S. 601, 39 L. ed. 1108, 15 Sup. Ct. Rep. 912, and quoted the Amendment, proceeded very properly to say (p. 704): 'It is manifest that the stock dividend in question cannot be reached by the Income Tax Act, *and could not, even though Congress expressly declared it to be taxable as income, unless it is in fact income.*' * * * * *

"* * * * * * *

"* * * We ruled at the same term, in Lynch v. Hornby, 247 U. S. 339, 62 L. ed. 1149, 38 Sup. Ct. Rep. 543, that a cash dividend extraordinary in amount and in Peabody v. Eisner, 247 U. S. 347, 62 L. ed. 1152, 38 Sup. Ct. Rep. 546, that a dividend paid in stock of another company, were taxable as income although based upon earnings that accrued before adoption of the Amendment. In the former case, concerning 'corporate profits that accumulated before the act took effect,' we declared (pp. 343, 344): 'Just as we deem the legislative intent manifest to tax the stockholder with respect to such accumulations only if and when, and to the extent that, his interest in them comes to fruition as income, that is, in dividends declared, so we can perceive no constitutional obstacle that stands in the way of carrying out this intent when dividends are declared out of a pre-existing surplus. . . . Congress was at liberty under the Amendment to tax as income, without apportionment, everything that became income, in the ordinary sense of the word, after the adoption of the Amendment, including dividends received in the ordinary course by a stockholder from a corporation, even though they were extraordinary in amount and might appear upon analysis to be a mere realization in possession of an inchoate and contingent interest that the stockholder had in a surplus of corporate assets previously existing.' In Peabody v. Eisner (pp. 349, 350), we observed that the decision of the district court in Towne v. Eisner had been reversed 'only upon the ground that it related to a stock dividend which in

fact took nothing from the property of the corporation and added nothing to the interest of the shareholder, but merely changed the evidence which represented that interest;' and we distinguished the Peabody Case from the Towne Case upon the ground that 'the dividend of Baltimore & Ohio shares was not a stock dividend, but a distribution in specie of a portion of the assets of the Union Pacific.'

"Therefore, Towne v. Eisner cannot be regarded as turning upon the point that the surplus accrued to the company before the act took effect and before adoption of the Amendment. And what we have quoted from the opinion in that case cannot be regarded as obiter dictum, it having furnished the entire basis for the conclusion reached. *We adhere to the view then expressed, and might rest the present case there; not because that case in terms decided the constitutional question, for it did not; but because the conclusion there reached as to the essential nature of a stock dividend necessarily prevents its being regarded as income in any true sense.*

"Nevertheless, in view of the importance of the matter, and the fact that Congress in the Revenue Act of 1916 declared (39 Stat. at L. 757, chap. 463, Comp. Stat., sec. 6336b, Fed. Stat. Anno. Supp. 1918, p. 312) that a 'stock dividend shall be considered income, to the amount of its cash value,' *we will deal at length with the constitutional question, incidentally testing the soundness of our previous conclusion.*

"The 16th Amendment must be construed in connection with the taxing clauses of the original Constitution and the effect attributed to them before the Amendment was adopted. In Income Tax Cases (Pollock v. Farmers Loan & T. Co.) 158 U. S. 601, 39 L. ed. 1108, 15 Sup. Ct. Rep. 912, under the Act of August 27, 1894 (chap. 349, sec. 27, 28 Stat. at L. 509, 553), it was held that taxes upon rents and profits of real estate and upon returns from investments of personal property were in effect direct taxes upon the

property from which such income arose, imposed by reason of ownership; *and that Congress could not impose such taxes without apportioning them among the states according to population, as required by art. 1, sec. 2, cl. 3, and sec. 9, cl. 4, of the original Constitution.*

"Afterwards, and evidently in recognition of the limitation upon the taxing power of Congress thus determined, the 16th Amendment was adopted, in words lucidly expressing the object to be accomplished: 'The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration.' As repeatedly held, this did not extend the taxing power to new subjects, but merely removed the necessity which otherwise might exist for an apportionment among the states of taxes laid on income. Brushaber v. Union P. R. Co., 240 U. S. 1, 17-19, 60 L. ed. 493, 501, 502, L. R. A. 1917D, 414, 36 Sup. Ct. Rep. 236, Ann. Cas. 1917B, 713; Stanton v. Baltic Min. Co., 240 U. S. 103, 112, et seq., 60 L. ed. 546, 553, 36 Sup. Ct. Rep. 278; William E. Peck & Co. v. Lowe, 247 U. S. 165, 172, 173, 62 L. ed. 1049-1051, 38 Sup. Ct. Rep. 432.

"A proper regard for its genesis, as well as its very clear language, requires also that this Amendment shall not be *extended by loose construction, so as to repeal or modify, except as applied to income,* those provisions of the Constitution that require an apportionment according to population for direct taxes upon property, real and personal. This *limitation* still *has an appropriate and important function, and is not to be overriden by Congress or disregarded by the courts.*

"In order, therefore, that the clauses cited from article 1 of the Constitution may have proper force and effect, save only as modified by the Amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is

not 'income,' as the term is there used; and to apply the distinction, as cases arise, according to truth and substance, without regard to form. *Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised.*

"The fundamental relation of 'capital' to 'income' has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time. For the present purpose we require only a clear definition of the term 'income,' as used in common speech, in order to determine its meaning in the Amendment; * * *"

"* * * 'Income may be defined as the gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the Doyle Case (pp. 183, 185).

"Brief as it is, it indicates the characteristic and distinguishing attribute of income, essential for a correct solution of the present controversy. The government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word 'gain,' which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived,—*'derived—from—capital;'—'the gain—derived—from capital,'* etc. Here we have the essential matter: *not* a gain *accruing* to capital, not a *growth*, or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital, however invested or employed, and *coming in*, being *'derived,'* that is, *re-*

ceived or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal; *that* is income derived from property. Nothing else answers the description.

"The same fundamental conception is clearly set forth in the 16th Amendment—'incomes, *from* whatever *source derived*,'—the essential thought being expressed with a conciseness and lucidity entirely in harmony with the form and style of the Constitution.

"* * * * * * *

"Throughout the argument of the government, in a variety of forms runs the fundamental error already mentioned—a failure to appraise correctly the force of the term 'income' as used in the 16th Amendment or at least to give practical effect to it."

"* * * * * * *

"Upon the second argument, the government, recognizing the force of the decision in Towne v. Eisner, 245 U. S. 418, 62 L. ed. 372, L. R. A. 1918D, 254, 38 Sup. Ct. Rep. 158, and virtually abandoning the contention that a stock dividend increases the interest of the stockholder or otherwise enriches him, insisted as an alternative that, by the true construction of the Act of 1916, the tax is imposed not upon the stock dividend, but rather upon the stockholder's share of the undivided profits previously accumulated by the corporation, the tax being levied as a matter of convenience at the time such profits become manifest through the stock dividend. If so construed, would the act be constitutional?

"That Congress has power to tax shareholders upon their property interests in the stock of corporations is beyond question; and that such interest might be valued in view of the condition of the company, including its accumulated and undivided profits, is equally clear. But that this would be taxation of property because of ownership, and hence would require apportionment under the provisions of the Constitution, is settled beyond peradventure by previous decisions of this court.

"The government relies upon The Collector v. Hubbard (Brainard v. Hubbard) (1870) 12 Wall. 1, 17, 20 L. ed. 272, 278, which arose under sec. 117 of the Act of June 30, 1864 (chap. 173, 13 Stat. at L. 223, 282, Comp. Stat., sec. 6368, 4 Fed. Stat. Anno., 2nd ed., p. 324), providing that 'the gains and profits of all companies, whether incorporated or partnership, other than the companies specified in this section, shall be included in estimating the annual gains, profits, or income of any person entitled to the same, whether divided or otherwise.' The court held an individual taxable upon his proportion of the earnings of a corporation although not declared as dividends, and although invested in assets not in their nature divisible. Conceding that the stockholder for certain purposes had no title prior to dividend declared, the court nevertheless said (p. 18): 'Grant all that, still it is true that the owner of a share of stock in a corporation holds the share with all its incidents, and that among those incidents is the right to receive all future dividends; that is, his proportional share of all profits not then divided. Profits are incident to the share to which the owner at once becomes entitled provided he remains a member of the corporation until a dividend is made. Regarded as an incident to the shares, undivided profits are property of the shareholder, and as such are the proper subject of sale, gift, or devise. Undivided profits invested in real estate, machinery, or raw material for the purpose of being manufactured are investments in which the stockholders are interested, and when such profits are actually appropriated to the payment of the debts of the corporation they serve to increase the market value of the shares, whether held by the original subscribers or by assignees.' In so far as this seems to uphold the right of Congress to tax without apportionment a stockholder's interest in accumulated earnings prior to dividend declared, it must be regarded as overruled by Income Tax Cases (Pollock v. Farmers Loan & T. Co.) 158 U. S. 601, 627, 628, 637, 39 L. ed. 1108, 1122, 1125, 15 Sup. Ct. Rep. 912. Conceding The Collector v. Hubbard was inconsistent

with the doctrine of that case, because it sustained a direct tax upon property not apportioned among the states, the *government nevertheless insists that the 16th Amendment removed this obstacle, so that now the Hubbard Case is authority for the power of Congress to levy a tax on the stockholder's share in the accumulated profits of the corporation even before division by the declaration of a dividend of any kind.* Manifestly this argument must be rejected, since the Amendment applies to income only, and what is called the stockholder's share in the accumulated profits of the company is capital, not income. As we have pointed out, a stockholder *has no individual share in accumulated profits,* nor in any particular part of the assets of the corporation, prior to dividend declared.

"Thus, from every point of view, we are brought irresistibly to the conclusion that neither under the 16th Amendment nor otherwise has Congress power to tax without apportionment a true stock dividend made lawfully and in good faith, *or the accumulated profits behind it,* as income of the stockholder. The Revenue Act of 1916, in so far as it imposes a tax upon the stockholder because of such dividend, contravenes the provisions of article 1, sec. 2, cl. 3, and article 1, sec. 9, cl. 4, of the Constitution, and to this extent is invalid notwithstanding the 16th Amendment." (Italics supplied.)

It may be that a more inclusive definition for *income* will be written but until done, the opinion in *Eisner* v. *Macomber, supra,* states the limitations upon the term. The provisions of the 1936 Revenue Act which tax to the corporation its *undistributed accumulated profits* for the failure to declare a *dividend* thereof, is unconstitutional and must fall for the failure to apportion such tax among the several states. Such conclusion is inescapable where (as in the Utah Hotel case, Appendix Exhibit "A") the corporation has an "impaired capital" as a result of an "operating deficit," for as said by Mr. Justice San-

ford in *Willcuts* v. *Milton Dairy Company, supra,* * * * "where capital is impaired, profits though earned and remaining in the business if *insufficient* to 'off-set' this impairment *do not* constitute 'undivided profits'." A more decisive statement could not be framed.

(b) That portion of the Revenue Act of 1936, which undertakes to tax the corporation for its undistributed corporate profits is (in the alternative) unconstitutional in that it is a penalty on conduct and in actuality represents an effort to "create a conduit to income" by "increasing the velocity of monetary cirulation."

It is conceded that Congress has the power under the Sixteenth Amendment to put a tax (of whatever proportion may be necessary for the operation of the government) upon the *income* of a corporation with net earnings. That is an *income tax* and is *constitutional.*

Furthermore, it has the sanctity of equality of treatment to all *corporate taxpayers.*

To plan a *devious* course, such as here complained of, *indicates* a *purpose* (such as in the Child Labor Cases, *infra,* p. 48) to *regulate economic conduct* under the *thin guise of raising revenue.*

There are but two considerations upon which the *tax* in question can be found to be an income tax; viz.,

(1) Congress has so named the Act,

and,

(2) that,

> "* * * a penalty measured by failure to disburse *undistributed* profits is a tax upon *net* income."

Upon subdivision (1) supra, there is presented the same "short question" that was before the United States Supreme Court in *St. Louis Cotton Compress* v. *Arkansas,* 260 U. S.

346, 67 L. ed. 297, where Mr. Justice Holmes, after observing (260 U. S., page 348)

> "The short question is whether this *so-called* tax is *saved* because of the name given to it by the statute, . . ." (Italics supplied.)

concluded,

> "* * * that the name given by the state to the imposition is not conclusive.";

and in the ultimate rule announced that, the name *did not save the Act.*

See also:

St. Louis S. W. Ry. Co. v. *Arkansas, ex rel. Norwood,* 235 U. S. 350-362, 59 L. ed. 265-271, 35 Sup. Ct. Rep. 99.

Subdivision (2), *supra,* presents the crux of the argument, and requires some notice of the economic problem involved.

In this connection we quote further from the article by John B. Martin, Jr., in the Michigan Law Review (cited supra) in the discussion of:

"Motivation for the Present Legislation

The motives behind the present bill are several. The primary motive is, of course, to raise additional revenue. A related fiscal motive is to prevent tax evasion; the attempts to prevent evasion, under sections 102 and 351, have not been successful." Motives which may be termed social and political aim at equalization of the tax burden between sole traders or

" Tax Message of President to Congress, March 3, 1936, 80 Cong. Rec., No. 45, p. 3235 (1936). Testimony of G. T. Helvering, S. Hearing, on H. R. 12395, 74th Cong., 2d sess., p. 22 (1936), showing possibility of evasion either in the payment of dividends in years when other income is small or in the fact that capital gains realized upon sale by reason of increased value of stock due to accumulation of earnings in surplus need be recognized only in part if the stock has been held for more than one year. It is also true that earnings which are now taxed might in the past never have paid a tax if carried to surplus but subsequently dissipated by bad management.

partners and corporate stockholders[45] and at forcing distribution of corporate profits to stockholders.[46] It may also be urged that the present tax plan seeks to help small business[47] and to check corporate bigness.[48] Finally, it has been suggest-

[45] Tax Message of President to Congress, March 3, 1936, 80 CONG. REC., No. 45, p. 3235 (1936). See testimony of Secretary Morgenthau, S. Hearing on H. R. 12395, 74th Cong., 2d sess., p. 5 (1936); and G. T. Helvering, ibid., p. 19. See proposal of National Association of Credit Men, 61 CONG. REC. 6851 (1921). This point appears sound and has the support of tax experts, but the problem cannot be oversimplified. The proposal to tax the corporation on income undistributed at the same rate that such income would be taxed if in the hands of stockholders cannot be achieved by any blanket schedule of rates such as are used in the Revenue Act of 1936. [On this point, see remarks of T. S. Adams, 16 PROC. NAT. TAX ASSN. 308 (1923).] Inevitably, except in fortuitous instances, the rates will result in a tax higher or lower than the *particular* individual would pay if he received the income in dividends. In general, the result would appear to be that men in the small surtax brackets will suffer most from the undistributed profits tax if the corporation retains any sizable portion of its income. The proposal of the House bill to divide corporations into those making more or less than $10,000 income might have partially reduced this inequity in so far as it can be said that the stockholders in small corporations are more apt to be in the lower surtax brackets. The specific credit of section 14 (c) of the final bill tends in the same direction. The inequality as to poor and rich stockholders of the *same* corporation remains. A truly equitable system can probably be achieved only by taxing to the corporation an amount equal to the sum of the taxes which would have been paid by the several stockholders on the corporate earnings had these been distributed and holding such undistributed amounts tax free in the case of any subsequent distribution. A method suggested by Dr. Adams as theoretically sound, but rejected by him as economically impractical, is to "put a tentative surtax on corporations high enough to make it to the interest of the corporation and its stockholders to elect 'voluntarily' to pay, in lieu of this tentative surtax, the ordinary or regular surtaxes on the stockholders' respective shares in the undistributed profits of the corporation. In short, make it profitable for the corporation and its stockholders to elect to pay taxes like the partnership and its members."

[46] Interview with the President, N. Y. TIMES, p. 1:4 (March 3, 1936). One basis for this argument seems to be the conviction that corporations, having obtained the stockholders' money, are proceeding to play fast and loose with it in disregard of stockholders' interests and should be forced to disgorge the full return on the investment. Whether such distributions should be sought for economic reasons is considered in the text, infra.

[47] See discussion of a related plan, referred to in note 13, supra, by J. F. Zoller, PROC. SECOND NAT. IND. TAX CONF. 196 (Oct. 1920), as a direct aid to small business. A diametrically opposed position has been taken by many witnesses. See text, infra.

[48] See the remarks of the President in discussing the question of corporate taxation in Message to Congress, June 19, 1935, in which he stresses the importance of small business to the national economy, adding that "Size begets

ed by the President that this tax will be of economic benefit in increasing the velocity of monetary circulation.[49]

Economic Questions Raised by the Surtax on Undistributed Corporate Profits

Most witnesses for or against the bill assumed that they knew how it would operate on the policies of companies affected. In general it was taken for granted that larger dividend distributions would result. The clearest fact emerging from testimony taken is that though the bill may be expected with reasonable certainty to raise revenue, since either the corporation or the stockholder will pay additional taxes, it cannot be predicated with any certainty that corporations will or will not distribute more dividends. If the rate of retention in the past has been dictated by prudence rather than by the desire of particular stockholders to avoid the surtax, as may be thought to have been true in the majority of cases,[50] then, it is reasonable to suppose that prudence will require the retention of this same amount *plus* enough to cover the additional tax. Dividends will to this extent be smaller rather than larger. Even if increased dividends are declared by boards of directors which are controlled by large stockholders, the increase will be limited by the fact that stockholders are not likely to urge the payment of any dividends which would have the ef-

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monopoly." 79 Cong. Rec. 9713 (1935). The storm of criticism leveled at this message seems justified in so far as it attacked the implication that corporate bigness is per se detrimental. From the economic standpoint, the bigger the corporation, assuming a corresponding increase in efficiency and consequent lower cost of production per unit, the greater benefit to the nation as a whole. This does not deny that regulation may be necessary, but it is highly questionable whether such regulation should be through taxation based upon size.

[49] Note 46, supra. What this means is not at all clear. It was apparently thrown out casually in answer to a reporter's question. Presumably it has a relation to the prevalent concept that a falling price level is a bad thing and that increased velocity of circulation will produce a rising level of prices. That a falling price level is not necessarily undesirable, see Durbin, Purchasing Power and Trade Depression 71-78, 173, 175-176 (1933); Moulton, Income and Economic Progress 117-141. Criticizing the President's reasoning, see Editorial, "Money Velocity," N. Y. Times, p. 14:1 (March 28, 1936).

[50] No satisfactory evidence has been offered as to the extent of *deliberate* tax evasion by means of restraining distribution of dividends. The most that can be said is that there has been some such evasion, that the mere existence of section 102 has probably forestalled such evasion in some cases, and that the number of actual cases under section 102 has been small.

fect of impairing the very safety of their capital investment. Where such control of directors is lacking, it is difficult to see why past policies of dividend declaration should be materially changed except as suggested above.

The argument urged by the opponents of the act that it will be impossible under the new tax to accumulate surplus does not carry much weight. The House bill was drawn so as to allow the addition of at least 30 per cent of earnings to surplus without subjecting the corporation to a greater tax than had been paid under the then existing act.[51] The corporation could, by refraining from distribution, add considerably more than this to surplus. Under the act as finally adopted, a corporation retaining forty per cent of a $100,000 income will pay approximately eighteen and one-half per cent on its total net income. If these several conclusions are correct, much of the argument that the national corporate financial structure will be undermined by the bill is irrelevant. The conclusions apply to the healthy corporations. The effect of the act in certain pathological cases will be referred to subsequently.

It should be noted that statements of Treasury officials in defense of the new act lay stress primarily upon the amount of liquid assets held by the corporations of the country.[52] This position shows at least one fundamental confusion in the minds of the supporters of the bill. It becomes clear from reading the testimony taken that what is really objected to is the accumulation by corporations of large amounts of *liquid* assets in the form of cash, bank deposits and security investments.[53] The act, however, does not aim at these items alone but at additions to surplus generally. This is highly important because the addition to liquid assets resulting from the earnings of a year's operations will almost invariably be a totally different figure from the figure for earnings transferred to surplus. Additions to surplus may be $1,000,000, while the increase in liquid assets may be nil or even a minus quantity.[54]

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[51] Testimony of G. T. Helvering, S. Hearing on H. R. 12395, 74th Cong., 2d sess., pp. 23-24 (1936).

[52] See text, infra, at notes 58 and 66.

[53] Whether such accumulations are detrimental has been to some extent considered in the text, supra.

[54] Testimony of W. H. Mooney, S. Hearing on H. R. 12395, 74th Cong., 2d sess., pp. 638-639 (1936), G. E. Holloway, ibid., pp. 694-695; testimony of R. G. Berry, H. Hearing on H. R. 12395, 74th Cong., 2d sess. pp. 844-845 (1936).

To tax additions to surplus as though they were liquid means that the corporation whose liquid capital has not been increased by earnings must borrow, draw down its cash reserves, if any, or liquidate some part of its plant, equipment, or inventory to pay dividends to avoid taxes, or it must pay taxes because of failure to pay sufficient dividends.[55] There does not seem to be any evidence that corporation surpluses, liquid or otherwise, are per se detrimental. In fact, the Treasury has recognized that to some extent at least they are desirable.[56] That liquid assets largely in excess of the needs of the business are undesirable is a possible though not proven economic hypothesis. Assuming its proof, however, if the aim is to do away with these accumulations, the method is not well adapted to the end, including as it does in its penalty, *all* additions to surplus from earnings.

It is contended by the Government[57] that such a bill will be a check on the severity of booms and depressions in that it will (a) be a brake on excessive expansion, (b) lessen speculation, and (c) maintain purchasing power because money will be distributed to stockholders. The arguments, it should be noted, are based upon a tacit assumption that distribution to stockholders will probably occur. While it is true that cash holdings of corporations increased 5.6 billions between 1926 and 1929,[58] we cannot ignore the conclusions of the Brookings Institution that between 1900 and 1930 the unutilized margin of productive capacity in the United States *did not increase* in manufacturing, electric power utilities, agriculture, mining (except for the dislocation of the war), and probably also construction and merchandising.[59] Only in transportation are

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[55] Testimony of N. Sargent, S. Hearing on H. R. 12395, 74th Cong., 2d sess., pp. 660-664 (1936). See the same criticism regarding depletion of working capital, 1 REPORT OF JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, 70th Con., 1st sess., p. 54 (1927).

[56] Testimony of G. T. Helvering, S. Hearing on H. R. 12395, 74th Cong., 2d sess., pp. 23-24 (1936).

[57] Testimony of H. Oliphant, S. Hearing on H. R. 12395, 74th Cong., 2d sess., p. 927 (1936).

[58] Ibid.

[59] NOURSE, AMERICA'S CAPACITY TO PRODUCE 421 ff. (1934). At p. 425, it is said, "Equipment was being maintained at a rate entirely suitable to the indefinite continuance of operations at the 1929 rate of activity. There was an unutilized margin which, in the perspective of the past, would appear to be about normal."

there indications of an increasing unproductive margin. A subsequent volume of the Brookings studies concludes that while *individual* savings increased in relation to the aggregate national income, *corporate savings,* through additions to surplus, though increasing in amount of dollars saved, did not constitute "any larger percentage of the national income in 1929 than they did 20 years earlier."[60] In the light of such findings, the argument that our productive capacity had been over expanded and that this was due to the accumulation of corporate surpluses is of doubtful validity.

That corporation cash reserves did contribute in some degree to the rise of stock prices through the device of brokers' loans is doubtless true, but any argument that these were solely or even primarily responsible must meet the fact that in 1929, for example, in addition to corporate savings of between two and three billions there were *individual* savings of some thirteen billion dollars available to force security prices upward. It is noteworthy that corporate financing, to increase plant and production through new stock issues, had, for the six years prior to 1929, stood at approximately five billion dollars annually and had in every year been less, by several billions of dollars, than the amount of savings flowing into the market to purchase securities.[61] The normal result of limited supply and heavy demand seems to have occurred as savings in excess of the amount required for the financing of new production were used to bid up stocks. It should also be remembered that corporate earnings in 1928 and 1929 were of a size to justify, at least in some part, the prices for equities then prevailing. The Treasury's argument as to the effect of corporate reserves upon speculation may therefore be easily overemphasized.

The view that earnings, retained by the corporation and appearing on its books as an addition to surplus at the end of the year, are withdrawn from the industrial economy and represent lost or delayed purchasing power is also doubtful economic theory. In the first place, a large part of such surplus is spent in production and in maintaining plant and equipment. To this extent it flows on down to the worker and in-

[60] LEVEN, MOULTON and WARBURTON, AMERICA'S CAPACITY TO CONSUME 100-108, 110 (1934).

[61] MOULTON, THE FORMATION OF CAPITAL 146-154 (1935).

creases purchasing power at a rate at least as great as if the same amount were distributed to stockholders who are primarily in a higher income class and therefore more likely to use their money in savings and investment than are wage earners. Nor can it be said that such portion of annual earnings as consists of cash and bank deposits is stagnant. Some part of these funds performs the very necessary economic function of a coverage for contingencies and immediate expenses. The part not so required gives support as bank deposits to the expansion of commercial loans.[62] The economic advantages urged in favor of the bill, therefore, do not appear to stand close inspection.

It has been argued to the contrary that accumulated reserves are available to prevent depressions from being so severe in that they allow the maintenance of some dividends and of employment which would not otherwise exist.[63] To this contention there is some merit if it be assumed that the undistributed profits tax will prevent the accumulation of surplus. As has been previously suggested, this will not necessarily be the result of the tax. If this assumption be made, however, that national corporate structure may suffer to the extent that smaller corporate surpluses might mean more quickly impaired capital in time of depression with a consequent restriction on dividends, and perhaps, a lessened ability to obtain credit. In recent years the surpluses of many firms have been substantially reduced. In some cases capital has been impaired. That the undistributed profits of the last boom were absorbed and existing surpluses heavily trenched upon by corporations as a whole is indicated in the fact that total dividends paid between 1921 and 1933, amounting to $50,700,000,000, exceed net earnings for that period by nearly 10 billion dollars.[64] It must nevertheless be kept in mind that corporate surplus may be almost entirely represented by plant and equipment rather than cash, and the mere fact that a cor-

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[62] MOULTON, THE FORMATION OF CAPITAL 107 (1935), stressing the effect of lending by the commercial banks in allowing the continuance over long periods of simultaneous consumption and saving.

[63] Testimony of N. Sargent, S. Hearing on H. R. 12395, 74th Cong., 2d sess., p. 666 (1936). Also, Seligman, "Tax on Surpluses Called a Danger," N. Y. TIMES, § 3, p. 1:1 (March 22, 1936).

[64] TREASURY STATISTICS OF CORPORATE INCOME, tabulated in BUL. NAT. CITY BANK 56 (April, 1936).

poration has piled up on its books a large surplus item does not mean that it will have liquid resources on which to draw in time of depression. It may even be forced into receivership with a surplus still recorded on its books. Thus, while a surplus in some instances may prevent the actual impairment of capital, the existence of a surplus on a corporation's books is no guarantee that the corporation will survive even a mild depression. It cannot be fairly said by opponents of the act that without a surplus a corporation must die in time of depression, leaving it to be implied that with a surplus it would survive. Nor can it be argued that the existence of a surplus means necessarily greater employment in depressed periods. A priori it would appear that corporations with liquid funds would husband them very carefully in time of depression. Statistically this seems correct. The Treasury figures show that disbursements in dividends did not exceed net receipts during the depression[65] and that *liquid* capital was not drawn down to maintain employment or pay dividends.[66] We may conclude that a large surplus is not indispensable to a corporation's continued existence even in time of depression, that the liquid part of corporate surpluses has not been used to maintain dividends or employment in depressed periods, but that the presence of a surplus may have had an effect on dividend payments in the case of corporations which could not otherwise have paid dividends because of *legal,* rather than financial, restrictions on the payment of dividends when capital is impaired. In short, neither the arguments set out by the Treasury in favor of the bill as a force in mitigating the sever-

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[65] Testimony of G. C. Haas, S. Hearing on H. R. 12395, 74th Cong., 2d sess., pp. 58-61 (1936).

[66] The figures cited show cash and investments of all non-financial corporations in 1929 at 32.7 billion dollars and in 1933 at 33.5 billion dollars. Per contra, the Department of Commerce in 14 SURVEY OF CURRENT BUSINESS 17 (Feb., 1934), says of 1923-1932:

"In large areas of the economic system, enterprises paid out in wages, dividends, interest, rents and the like, more dollars than they received for the goods and services which they produced. Such withdrawals represent a draft upon previously accumulated surplus and assets which are possibly derived in part from the creation of new debt obligations, which would be in effect a withdrawal currently of anticipated future income. For corporations alone the excess paid out amount to about 7 billion dollars; this was almost three times the net dividends paid and the major portion must, therefore, have gone to sustain other payments, such as salaries and wages and interest."

ity of depressions nor the arguments of opponents of the bill as to the importance of having large surplus cushions to soften the depressions's pinch carry very great conviction. The arguments have been pressed far beyond their merits on both sides.

Finally much has been said on the question of hardship on the small corporation.[67] Will the act injure the ability of the small corporation to finance its needs and so injure its owners? In answering this question, it should be remembered that financing for the small corporation has always been a somewhat difficult task. It must be agreed that for the small corporation to attempt to finance itself through the security markets is out of the question both because of the expense involved and because of the fact that a market could be established only with difficulty for securities of small companies with an essentially local reputation.[68] On the other hand, it is urged by the Treasury that the difficulty of obtaining finances for small corporations will not be increased even though the present act should force distribution of earnings and even though resort cannot be had to the security markets. It is contended that the one exception will be the case where stockholders, receiving dividends, refuse to reinvest such funds as are needed by the company and the argument is fairly cogent that since the stockholders are owners of the company, if they refuse to reinvest, it can be no cause for complaint by anyone. The question of business expansion is one which the owners of the business alone may properly determine. In addition it is said that the small corporation does not need the security markets in any event, but will finance its needs, as in the past, by personal and informal negotiation with its stockholders.[69] The argument is further adduced that since the principal stockholders of small corporations are generally in lower income brackets than the principal stockholders of large corporations, the former will pay less income tax on the divi-

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[67] Testimony of R. L. Sweet, S. Hearing on H. R. 12395, 74th Cong., 2d sess., p. 165 (1936); of H. B. Fernald, ibid., p. 249; of E. C. Alvord, ibid, p. 286; of G. O. May, ibid., p. 544; and of N. Sargent, ibid., p. 668.

[68] As to the extent of reliance by small companies on the security market for financing, see U. S. Dept. of Commerce Business Advisory Council, Survey of Reports of Credit and Capital Difficulties Submitted by Small Manufacturers, pp. 1-4 (April 15, 1935).

[69] Testimony of H. Oliphant, S. Hearing on H. R. 12395, 74th Cong., 2d sess., pp. 917-918 (1936).

dends received and, relative to the amounts distributed, will have more to reinvest.[70] Whatever these latter points are worth, it seems true that an inability to get the owners of a business to put their earnings back into it cannot be spoken of as "hardship on the corporation" unless the doubtful position is taken that stockholders, once in, have an obligation to play ball, whether they like the game or not, for the benefit of the officers and other stockholders.

One objection, however, may be made to the government's position regarding the way in which corporations should refinance. which applies to both large and small corporations. If the act leads to the retention by corporations of the same amounts as have been withheld from dividends in the past, plus enough to cover the new tax, corporate financing will continue as in the past to come largely from additions to surplus. Upon the alternative assumption, however, that the act will result in greater dividend distributions, the sale of additional stocks and bonds as a means of financing corporate needs may decrease the stability of the corporate structure as a whole. The method of financing by additions to surplus does not result in increased indebtedness, as must be true if bonds or notes are issued. Nor do such additions to surplus result in an increased capitalization, such as results if stock is sold rather than bonds. During depression a large b o n d e d indebtedness has been found to be a stone around the neck of many corporations, necessitating reorganization. Likewise a high capitalization tends to result in impaired capital in times of stress and, because of the restrictions in most state corporation acts on payment of dividends when capital is impaired, may also have an unsettling effect on the business structure."

A further capable discussion of the problem is found in "Taxes" (a tax magazine), issue of September 19, 1939, at pages 516-517, by William J. Shultz of the School of Civic Ad-

[70] Testimony of G. C. Haas, S. Hearing on H. R. 12395, 74th Cong., 2d sess., pp. 36-37 (1936).

ministration of the College of the City of New York, which we also quote:

TAXES—The Tax Magazine, September, 1939.

"The Undistributed Profits Tax

Taxation of undistributed corporate profits was proposed by the Administration in 1936, and reluctantly accepted by Congress. President Roosevelt intended that a levy on undistributed profits, at substantial rates, should be the only tax on corporations; Congress balked at such a far-reaching application of an untried principle, and enacted the tax as a supplementary levy, superimposed on the pre-existing corporate income, excess profits, and capital stock taxes. The rate of the undistributed profits tax, under the 1936 act, ranged from 7 per cent to 27 per cent according to the fraction of the corporation's income not distributed as dividends during the year.

Directly and indirectly, this tax was intended to be a revenue producer. Some tax would be paid by corporations which held back part of their year's earnings. And to the extent that the tax forced larger dividend payments than would otherwise have occurred, it would increase the personal incomes of the dividend receivers and so make them liable to larger personal income taxes. But an expansion of federal revenue was only one of the virtues of this tax to President Roosevelt and his advisers, and possibly only a minor one; much more important to their view was the effect this tax would have upon the rate and character of the saving process and upon the democratization of corporate management.

The ideas of 'excess savings' and 'improperly invested savings' as causative factors of business fluctuation were forced upon popular attention by a number of writers during the 1930's. Corporate savings were denounced as a particularly vicious type of saving; they contributed to 'excess' accumulations of savings, and their investment was likely to produce economically injurious effects.[1] Why not cut the

[1] See Rexford G. Tugwell, *The Battle for Democracy* (Columbia University Press, New York, 1935), Chapter XXI; David Cushman Coyle, *Brass Tacks* (National Home Library Foundation, Washington, 1935), p. 22.

taproot of the evil, argued these writers, by penalizing corporate saving? Individual recipients of the extra dividends distributed because of the tax will save only part of these 'windfall' receipts, whereas the corporations would have saved all; thereby 'excess' saving will be reduced. And to the extent that the recipients of these extra dividends do invest them, they will do so more wisely than the corporate management, since they will survey the entire investment field in determining the placement of their funds, while corporate managements can have only a limited investment vision.

President Roosevelt's comments on the undistributed profits tax in 1936 and 1938 indicate that he was considerably influenced by this line of reasoning. Even more was he won to the tax by the argument that it would promote democracy in corporate management. The power of corporate boards—particularly the boards of large corporations whose shares are widely held—over the disposition of undistributed profits is, for all practical purposes, absolute. They can use them to pay off bank loans, accumulate 'dead' balances, enlarge their properties and operations, or buy into control of other corporations, with no other accountability to the stockholders than the annual farce of the proxy-dominated election. But if a tax law imposes a substantial penalty upon the accumulation of profits, this oligarchic dominance of corporate finance policy is weakened, if not ended. A corporate board without accumulated profits at its command must submit its plans for expansion, for new investment, to the judgment of the corporation's shareholders and of the general investment market. Perhaps the shareholders will agree with the management, and will reinvest their extra dividends in new shares. Perhaps the market will ratify the decision by taking up a new issue on favorable terms. The purposes of the undistributed profits tax are nonetheless served.

Criticism of the undistributed profits tax was immediate, violent, and based upon considerable reason. Opponents of the tax flatly denounced the whole theory of 'excess' savings—and while their denunciation went too far in that it denied any element of validity to the theory, still they were on sound ground since the proponents of the theory cer-

tainly had not established it sufficiently firmly to serve as foundation for taxes specifically intended to *reduce* savings. These critics pointed out a regulatory effect overlooked by champions of the tax—that accumulation of profits was more common to small but growing enterprises that did not have ready access to the general investment market than to large established corporations, so that the tax discriminated against the progressive small company.

The 1936 statute was badly drafted and worked unnecessary inconvenience. A concerted drive in 1938 to wipe out the undistributed profits tax failed, but the tax was reduced to a modest 2½ per cent credit for distributed dividends allowed against corporation income tax liability. Supporters of the tax saw in the 2½ per cent distributed profits credit a mere shadow of an effective undistributed profits tax. However, the tax was repealed by the Revenue Act of 1939."

Notwithstanding all of the doubts as to the economic problems involved in the statute (concerning which we have trespassed upon the court's time to indicate) the legal problems do not seem to be in such confusion.

There are certain basic legal principles upon which there cannot be disagreement.

First:

> "* * * Corporations may accumulate what profits they please, so long as they *do not do so* to defeat the fiscal policies of the United States. Their business whose regulation *is wholly for* the States, does not include the manipulation of dividends to avoid taxes: by definition that has nothing to do with the normal management of their affairs. Congress in raising revenue has incidental power to defeat obstructions to that incidence of taxes which it chooses to impose."

See:

United Business Corporation v. *Commissioner*, 62 F. (2d) 754;

Certiorari denied, Oct. 9, 1933, 78 L. ed. 552.

Upon a first reading of the foregoing quoted portion of Judge Hand's opinion, one might assume that its context relates to the question here.

In fact what was there said, had solely to do with a *penalty* statute (Sec. 220 Rev. Act of 1921) enacted for the punishment of the creation of a device to avoid the imposition of an otherwise valid *income* tax. That provision of the law in substance *remained in effect during 1936* (as Sec. 102 of the Revenue Act of 1936) and did not (in *United Business Corporation* v. *Commissioner, supra)* have to do with the question of the power of Congress *to pass* that Act.

What Judge Hand was considering might be likened to the penalty for failure to file an income tax return due on March 15th in any year. That penalty is fixed as punishment for an attempt to defeat by obstruction a fiscal policy of the United States.

The imposition of a penalty for *failure to file* a return due, does not determine the right to deductions upon the return when filed, or the constitutionality of a tax upon the *retention* in accumulated surplus, of undistributed profits earned in such year.

In *Willcuts* v. *Milton Dairy Company,* 275 U. S. 215, 72 L. ed. 248, Mr. Justice Sanford in distinguishing "surplus" and "undistributed profits" laid down certain basic definitions which are of *importance* in the consideration of the validity of an income tax upon "undistributed profits."

We quote from that opinion:

> "We think that clause (3) relating to 'surplus and undivided profits' was correctly interpreted by art. 838 of the Treasury Regulations. *Both these terms as commonly employed in corporate accounting denote an excess in the aggregate value of all the assets of a corporation over the sum of all its liabilities, including capital stock.* See Edwards v. Douglas, 269 U. S. 204, 214, 70 L. ed. 235, 240, 46 Sup. Ct. Rep. 85;

Insurance Co. of N. A. v. McCoach, (D. C.) 218 Fed. 905, 908. Aside from the fact that a surplus may not only be 'earned,' as where it is derived from undistributed profits, but 'paid in,' as where the stock is issued at a price above par, the distinction between these terms, as commonly employed, is that the term 'surplus' describes such part of the excess in the value of the corporate assets as is treated by the corporation as part of its permanent capital, usually carried on the books in a separate 'surplus account;' while the term 'undivided profits' designates such part of the excess as consists of profits 'which have neither been distributed as dividends nor carried to surplus account.' Edwards v. Douglas, supra, 214. But it is a prerequisite to the existence of 'undivided profits' as well as a 'surplus,' that the net assets of the corporation exceed the capital stock. *Hence, where the capital is impaired, profits, though earned and remaining in the business, if insufficient to offset this impairment do not constitute 'undivided profits.'*

"We cannot doubt that this term was used in clause (3) with its ordinary meaning, nor agree with the view of the circuit court of appeals that the arbitrary definition given by the act to the term 'invested capital,' not equivalent to that of the ordinary invested capital of commerce, indicates that the words 'surplus and undivided profits' were not used with their ordinary meaning as conditioned by an excess of assets. We do not think Congress intended that a corporation whose capital was impaired *should be entitled to treat profits that, though earned, were insufficient to make good the impairment and create a surplus, as 'undivided profits.'* This would not only give the term 'undivided profits' a meaning entirely at variance with ordinary usage—making it merely equivalent to any earned profits remaining in the business—but would grant the privilege of twice disregarding the impairment of capital, that is, once in computing the paid-in capital, which under the express terms of the act was to be taken at the full cash or money value at the time of payment, and again in

computing the 'undivided profits.' This term is entirely inapt to express such a purpose." (Italics supplied.)

Consistency is a rare jewel, and "undistributed profits" and "surplus" remain and must be defined in terms of the same quotient, whether for "deduction" purposes as in *Willcuts* v. *Milton Dairy Co., supra,* or for "tax" purposes as in this case.

See:

McLaughlin v. *Baker, Hamilton & Pacific Co.,* 31 F. (2d) 546.

One other important decision relates to the interpretation made by Judge Hand in *United Business Corporation* v. *Commissioner, supra, viz.,*

Helvering v. *Nat. Grocery Co.,* 304 U. S. 282, 82 L. ed. 1346.

This much cited, but not carefully analyzed, decision is authority *only* for the position that a corporation *owned beneficially entirely* by a *single* stockholder (Henry Kohl), may be *penalized* for the adoption of a *device* such as that employed to enable such corporation to permit

"* * * gains and profits to accumulate instead of being divided or distributed.",

for the *purpose of preventing the imposition* of surtaxes upon such shareholder (or shareholders, if more than one) employing such device.

The important thing to remember in connection with this decision is that (headnote 1, page 286),

"The National Grocery Company *concedes* that Sec. 104 (which remained in effect as Sec. 102 in the Revenue Act of 1936) is constitutional *as applied* to a corporation *organized for the purpose of preventing* the imposition of surtaxes on its shareholders, but *urges* five reasons why it should be held void as applied to a

> *legitimate* business corporation which is '*availed of*' for the forbidden purpose. None of these reasons is sound."

Under this (as well as all other prior decisions) the statutes being considered had to do with *penalties* against the creation of an obstruction to the fiscal policy of the United States (and that fact had to be so found in each instance), whereas, the law here attacked, has to do with a tax levied without regard to evasion of fiscal policy or the organization of the offending corporation for such wrongful purpose.

Furthermore, the *second* of the *five* contentions by the Grocery Company, was the only one made that bears any relation to the present consideration.

For the convenience of the court we quote the *second* contention:

> [288]
>
> "*2.* It is said that the statute is unconstitutional because the liability imposed is not a tax upon income, but a penalty designed to force corporations to distribute earnings in order to create a basis for taxation against the stockholders. If the business had been carried on by Kohl individually, all the year's profits would have been taxable to him. If, having a partner, the business had been carried on as a partnership, all the year's profits would have been taxed to the partners individually, although these had been retained by the partnership undistributed. See *Heiner* v. *Mellon,* Nos. 144 and 145, decided May 16, 1938 (304 U. S. 271, *ante* 1337, 58 Sup. Ct. 926).
>
> "Kohl, the sole owner of the business, could not, by conducting it as a corporation prevent Congress if it chose to do so, from *laying on him individually the tax* on the year's profits.
>
> "If it preferred, Congress could lay the tax upon the corporation as was done by Sec. 104. The *penal nature* of the imposition does not prevent its being

valid as the tax was otherwise permissible under the Constitution.

Compare *Helvering* v. *Mitchell*, 303 U. S. 391, *ante* 917, 58 Sup. Ct. 630."

Section 104 of the Revenue Act of (May 29) 1928, Chap. 852, 45 Stat. at Large 791, 26 U. S. C. A., Sec. 104, note, provides:

> "*(a)* If any corporation, however created or organized, is *formed or availed of for the purpose* of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected and paid, for each taxable year *upon the net income* of such corporation a *tax* equal to 50 per centum of the *amount* thereof, which shall be in addition to the tax imposed by Sec. 13."

It was the constitutionality of this section that *was conceded* by the Grocery Company. Its defense according to Mr. Justice Brandeis was that,

> "it should be held void as applied to a *legitimate* business corporation which is 'availed of' for the forbidden purpose."

Whether Mr. Justice Brandeis' opinion is based upon the conclusion that the Grocery Company was not a "legitimate business corporation" or was merely a corporation engaged in "a fraudulent effort to defeat the fiscal policy of the United States" (discussed by Judge Hand in *United Business Corporation* v. *Commissioner, supra)* is not clear from the opinion but is of passing importance.

The citation of *Helvering* v. *Mitchell*, 303 U. S. 391 (ante 917), 58 Sup. Ct. Rep. 630, 82 L. ed. 917, by Mr. Justice Brandeis, as authority for overruling the Grocery Company's *second contention*, clearly shows that *fraud* and attendant penalty was the basis for the rule.

There remains a vast difference between a *penalty for fraud* and a *tax* for the *failure to distribute* earnings. The latter admittedly may be levied by Congress, but not as an *income tax.*

Of important consideration in connection with the petition for the writ in this case, is the *concession* of constitutionality upon the part of the petitioner (whose complaint involves but a small amount of tax, *viz.*, approximately $1700.00) in its failure to challenge the invalidity of the act save in the respect of its sole contention as to its charter from the state constituting a contract to be given effect within the exemption provisions of the statute. Such concession by the petitioner should not be received as a concession of constitutionality upon the part of every taxpaying corporation affected by the complained of statute.

The unfortunate consequence of such conclusion is doubly disastrous (where as here) tax paying corporations having large tax liability, and believing the law to be invalid (by reason of mere delay in securing an adjudication upon the constitutional questions in their respective circuits) are unable to have had their objections to the constitutionality of the act ruled upon before an order will be entered in this court in this cause which *may preclude* these taxpayers from thereafter having such constitutional objections *ruled upon at all.*

The denial of the writ upon the skeleton record in this cause and the sole question presented thereon will foreclose the constitutional objections to the act which are over and above the objection urged by petitioner, and these taxpayers are therefore greatly concerned that such constitutional objections shall be brought to the attention of this Honorable Court, and therefore respectfully ask that this brief *amici curiae* be received and considered in support of the allowance of a writ to review the whole of the constitutional questions involved.

Second:

The Sixteenth Amendment did not *extend* the Federal taxing power to *new subjects*, but merely removed the necessity for apportionment of taxes laid on income.

A tax laid on *income* which has become *accumulated capital*, would be *invalid* unless apportioned and it must be conceded that income in time *becomes* accumulated property.

Each of the income tax measures adopted since 1862 has applied to income *earned during* the entire calendar year. All of them have been sustained against this exception and all other objections except the Act of 1894 which was held unconstitutional in *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U. S. 429, 15 Sup. Ct. 912 (1895), 39 Law. ed. 1108, *as being a direct tax unapportioned.*

It is evident that the complained of tax is a *direct* tax upon property and must be *apportioned* for the identical reasons given by the Supreme Court in the Pollock case, supra; as a result of which this Act *must be* held to be unconstitutional in so far as it proposes to place a *so-called income tax* upon *property accumulations.*

The foundation for the *tax* upon the *undistributed corporate surplus* is found in Mr. Justice Brandeis' dissenting opinion in Eisner v. Macomber, supra, and its *fruition* represents an effort to accomplish by *legislative fiat* what the majority of the Supreme Court has for more than twenty years refused to approve, or has been unwilling to accept, as constitutional.

The entire purpose of the legislation represents a startling departure from constitutional land marks, and while appearing innocent enough in so far as *basic* rights are concerned will not withstand scrutiny in that respect.

The warning which is carried by this legislation is that if Congress may for such purpose regulate *any* conduct by the use of a revenue measure, then it may for many purposes *reg-*

ulate all conduct. Again, if Congress may by the use of a revenue measure say to the corporation what shall be done with its earnings, after an income tax has been once paid thereon and such earnings thereby *cleared* for *disposition* as ownership shall dictate, just as certainly may Congress determine by the employment of other *revenue* measures how much of the individual's *earnings* shall go into the *"conduit of income in the interest of velocity* of *monetary circulation,"* and to what extent departures from such standard of conduct shall be taxed.

Is it not apparent that such legislation violates every principle of constitutional government as that term has always been interpreted in this country?

It has been by such invasions of basic liberties (subtly) taken in exchange for temporary expediency that the collapse of free governments has been brought about.

The dollars taken from the offending corporation are but as trash when compared to the priceless jewel of constitutional government which is tarnished by this legislation.

If it be desirable, in the interest of the public welfare, to say the corporation *shall not accumulate* a surplus *let it be so written* upon the rock of constitutional guaranties but never *upon shifting sands in the base alloy of hypocrisy.*

The repeal of the offensive legislation by Congress while evidencing public sentiment does not meet the challenge.

In the courts, which have always been the Anglo-Saxon bulwark of human liberty, let it continue to be said in language that may be understood by all, that *revenue legislation* with an *ulterior purpose* has no place in a government of free people.

Hammer v. *Dagenhart,* 247 U. S. 251, 62 Law. ed. 1101, 3 A. L. R. 649, 38 Sup. Ct. Rep. 529, Ann. Cas. 1918E, 724.

Bailey v. *Drexel Furniture Co.,* 259 U. S. 20, 66 Law. ed. 817, 42 Sup. Ct. Rep. 449, 21 A. L. R. 1432.

Linder v. *U. S.,* 268 U. S. 5, 17, 69 Law. ed. 819, 823, 45 Sup. Ct. R. 446.

We cannot more aptly express our position than to quote from Chief Justice Taft in the *Drexel Furniture Company* case, *supra:*

> "* * * The good sought in unconstitutional legislation is an insidious feature because it leads citizens and legislators of good purpose to promote it without thought of the serious breach it will make in the ark of our covenant, or the harm which will come from breaking down recognized standards.
>
> "In the maintenance of local self-government, on the one hand, and the national power, on the other, our country has been able to endure and prosper for near a century and a half.
>
> "* * * in the act before us, the *presumption of validity* cannot prevail, because the proof of the contrary is found on the very face of its provisions. Grant the validity of this law, and all that Congress would need to do hereafter, in seeking to take over to its control any one of the great number of subjects of public interest, jurisdiction of which the states have never parted with, and which are reserved to them by the 10th Amendment, would be to enact a detailed measure of complete regulation of the subject and enforce it by a so-called tax upon departures from it. To give such magic to the word 'tax' would be to break down all constitutional limitation of the powers of Congress and completely wipe out the sovereignty of the states."

(c) The complained of provisions of the Revenue Act of 1936 are unconstitutional and invalid in that the Act discriminates against corporations (such as the Utah Hotel Company) with no "earnings or profits accumulated after February 28, 1913" in that such corporations are required to pay the tax unless a dividend (as defined by the Act, which we say is contrary to the meaning of that term within the limitations of the Sixteenth Amendment, as defined in Eisner v. Mac-

omber, supra), be made to stockholders which (under such circumstances) could but be solely a return of capital.

The *dividends paid credit* (see Sec. 27, Revenue Act of 1936) is:

(a) the amount of "dividends" paid,

or,

(b) that part of a distribution in liquidation of the company which is properly chargeable to the *earnings or profits accumulated after February* 28, 1913.

Dividends as used in Section 27, are defined by Section 115:

"(a) *Definition of Dividend.*—The term 'dividend' when used in this title means any *distribution* made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) *out of the earnings or profits of the taxable year* (computed as of the close of the taxable year), *without regard to the amount of the earnings and profits at the time the distribution was made.*

"(b) *Source of Distribtuions.*—For the purposes of this Act every distribution is made out of *earnings* or *profits* to the extent thereof, and from the most recently accumulated earnings or profits."

Sec. 115 (a) (2), *supra,* was new in the 1936 Act, and a very substantial extension of the definition of the term "dividend" contained in all prior acts. That new definition in so far as it includes in income a distribution made to stockholders by a corporation which had no accumulated surplus, income, earnings or profits, is unconstitutional, for the reason that such distributions cannot be taxed as "income", as that term was used in the Sixteenth Amendment and defined in *Eisner* v. *Macomber, supra.*

Under such circumstances, any distribution by a corporation with an "operating deficit", or at best a "surplus by appraisal" only, (as in the *Northwest Steel Rolling Mills* case) *could be nothing more* than a return to its stockholders of their proportionate interest in the corporation's capital. Such distribution does not become income, as defined in *Eisner* v. *Macomber, supra,* or in the *United States* v. *Safety Car Heating Company* case, *supra,* as well as in many other decisions by the Supreme Court of the United States.

In this connection, and for interpretative purposes, the Senate Finance Committee Report No. 2156, 74th Cong. 2d Sess., pp. 18, 19, should be quoted. It reads:

> "Section 115 (a). *Dividends Out of Current Earnings.* In order to enable corporations without regard to deficits existing at the beginning of the taxable year to obtain the benefit of the dividends paid credit for the purposes of the undistributed profits surtax, section 115 (a) changes the definition of a dividend so as to include distributions out of the earnings or profits of the current taxable year. The amendment simplifies the determination by providing that distributions during the year, not exceeding in amount the current earnings, are dividends constituting taxable income to the shareholder and a dividends paid credit to the corporation. As respects such dividends the complicated determination of accumulated earnings or profits is rendered unnecessary."

As to a *dividend paid credit* for surtax purposes, however, Sec. 27(h) provides:

> "If any part of a distribution * * * is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made no *dividends paid credit* shall be allowed with respect to such part."

That is to say, that unless *any distribution* made *be reported*

by the recipient stockholder as income, the corporation *must pay the surtax.*

As to distributions in liquidation, Sec. 27(f) provides:

> "Distribution in Liquidation.—In the case of amounts distributed in liquidation the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, shall, for the purpose of computing the dividends paid credit under this section, be treated as a taxable dividend paid."

It is obvious, therefore, that such corporations as Northwest Steel Rolling Mills, the Utah Hotel Company, the Crane-Johnson Company, as well as all other corporations, *without accumulated profits or earnings* after February 28, 1913, *could find no relief from the tax by liquidating.*

The Commissioner anticipated an adverse ruling by the courts upon the situation to which we direct attention, and has given a taxpayer something Congress did not authorize or the language employed contemplate.

First. Read Section 27(f) of the Act, and then examine the following quoted ruling; viz., I. T. 3067-XVI-16-8647:

> "REVENUE ACT OF 1936
>
> The M Corporation which was completely liquidated in 1936, is entitled to a dividends paid credit under section 27(f) of the Revenue Act of 1936 to the full extent of the earnings and profits for that year which were distributed, regardless of the fact that the corporation had an operating deficit at the beginning of the taxable year in excess of the earnings and profits for that year.
>
> Advice is requested whether the M Corporation upon its liquidation in the year 1936 is entitled to a dividends paid credit under section 27(f) of the Revenue Act of 1936 where its operating deficit at the beginning of the year 1936 exceeded its earnings and profits for that year to the date of liquidation. It is

stated that in the liquidation of the M Corporation in the year 1936 all assets, including earnings for that year, were distributed to shareholders, that no part of the assets was transferred to another corporation, and that the M Corporation discontinued operations in that year.

Section 27(f) of the Revenue Act of 1936 provides that:

> "'(f) *Distributions in Liquidation.*—In the case of amounts distributed in liquidation the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, shall, for the purposes of computing the dividends paid credit under this section, be treated as a taxable dividend paid.'

Section 14 of the Act imposes a surtax on *undistributed* profits. That surtax is measured by the '*undistributed* net income' of the corporation. Congress contemplated in the enactment of the statute an accumulation of current profits retained in fact by the corporation, a current accumulation withheld by the corporation from distribution to shareholders. It is obvious that in the case of a complete liquidation of a corporation no income remains undistributed and, therefore, there is nothing to which the undistributed profits tax is applicable. In this situation it is immaterial whether the prescribed distribution takes the form of an ordinary dividend or a distribution in liquidation.

In view of the above, it is held that in the case of the complete liquidation of the M Corporation the corporation is entitled to a dividends paid credit for the year 1936 to the full extent of the earnings and profits for that year which were distributed, regardless of the fact that the corporation had an operating deficit at the beinning of the taxable year in excess of the earnings and profits for that year."

The effect of this ruling is to say, that in the case of a *dissolving* corporation the quoted provisions, supra, of section 27(f) of the Act will be ignored *by the Commissioner* and the

corporation released of tax liability, quite evidently upon the theory that the corporation in *going out of business* was doing all that it could possibly do to comply with the *economic* theory back of the passage of the law.

The Treasury Department in Internal Revenue Bulletin 1937-2, page 134, General Counsels Memoranda, 18602, XVI-32-8862, page 2, further anticipating the ridiculous position that would result from the assertion that Section 27(f)—limited *dividend paid credit* to the total of earnings or profits accumulated after February 28, 1913, ruled that:

> "A is entitled to a *dividend paid credit regardless* of whether the distributions are taxable in the hands of the shareholder." (Citing: I. T. 3067 XVI-16-8647.)

This ruling is in the face of the plain language of 27(h) (quoted supra) as follows:

> "If any part of a distribution * * * is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made no *dividends paid credit* shall be allowed with respect to such part."

That attached hereto as Appendix Exhibit "A" is a certified copy of the undetermined complaint in the suit of the *Utah Hotel Company, a corporation,* v. *Ira N. Hinckley, Collector of Internal Revenue,* U. S. District Court for the District of Utah, Civil No. 84 (in which answer has just been filed by the Government), which complaint sets forth a concrete situation such as complained of in this subdivision of the foregoing brief.

That also attached hereto as Appendix Exhibit "B" is a certified copy of the undetermined petition of the *Peppers Gasoline Co.* v. *Commissioner,* No. 96981, United States Board of Tax Appeals, which exemplifies a situation which compels that taxpayer to *distribute* earnings to avoid the penalty of the tax when debts of more than $150,000.00 (upon some of

which large monthly payments were obligated by written contracts executed and delivered prior to the passage of the law) are outstanding against its business, which obligations were made for physical betterments and improvements constructed *prior to the passage of the law requiring such distribution of earnings.*

That also printed as Appendix Exhibit "C," are copies of briefs in *Northwest Steel Rolling Mills Inc.*, v. *Commissioner*, pending as No. 9207 in the Circuit Court of Appeals for the Ninth Circuit (argued orally December 5, 1939, at San Francisco) but not yet decided.

That the complained of provisions of the Revenue Act of 1936 deny to the Utah Hotel Company, Peppers Gasoline Company and Northwest Steel Rolling Mills Company, as well as a great number of other taxpaying corporations throughout the United States, the due process and equal protection of the laws guaranteed by the Fifth Amendment to the Federal Constitution.

In *Louisville Joint Stock Land Bank* v. *Radford*, 295 U. S. 589, 79 Law. ed. 1605, it was said by Mr. Justice Brandeis that,

> "*Fourth.* The bankruptcy power, *like the other great substantive powers* of Congress is subject to the Fifth Amendment."

The following cases are cited in Note 20 (to the opinion) in support of the conclusion so announced:

> "For instance, the war power, *Ex parte Milligan*, 4 Wall. 2, 119, 18 L. ed. 281, 295; *Ochoa* v. *Hernandez y Morales*, 230 U. S. 139, 153, 154, 57 L. ed. 1427, 1434, 1435, 33 S. Ct. 1033; *Hamilton* v. *Kentucky Distilleries & Warehouse Co.*, 251 U. S. 146, 155, 64 L. ed. 194, 198, 40 S. Ct. 106. *The power to tax, United States* v. *Baltimore & O. R. Co.*, 17 Wall. 322, 21 L. ed. 597; *Boyd* v. *United States*, 116 U. S. 616, 29 L. ed. 746, 6 S. Ct. 524; *Nichols* v. *Coolidge*, 274 U. S. 531, 542, 71 L. ed. 1184, 1192, 47 S. Ct. 710, 52 A. L. R.

1081; *Blodgett* v. *Holden*, 275 U. S. 142, 147, 72 L. ed. 206, 210, 48 S. Ct. 105; *Barclay & Co.* v. *Edwards*, 267 U. S. 442, 450, 69 L. ed. 703, 706, 45 S. Ct. 135, 348; *Heiner* v. *Donnan*, 285 U. S. 312, 326, 76 L. ed. 772, 779, 52 S. Ct. 358. The power to regulate commerce, *Monongahela Nav. Co.* v. *United States*, 148 U. S. 312, 336, 37 L. ed. 463, 471, 13 S. Ct. 622; *United States* v. *Joint Traffic Asso.*, 171 U. S. 505, 571, 43 L. ed. 259, 288, 19 S. Ct. 25; *Carroll* v. *Greenwich Ins. Co.*, 199 U. S. 401, 410, 50 L. ed. 246, 250, 26 S. Ct. 66; *United States* v. *Lynch*, 188 U. S. 445, 471, 47 L. ed. 539, 549, 23 S. Ct. 349; *United States* v. *Cress*, 243 U. S. 316, 326, 61 L. ed. 746, 752, 37 S. Ct. 380. The power to exclude aliens, *Wong Wing* v. *United States*, 163 U. S. 228, 236-238, 41 L. ed. 140, 143, 16 S. Ct. 977. Compare *Perry* v. *United States*, 294 U. S. 330, *ante*, 912, 55 S. Ct. 432, 95 A. L. R. 1335."

(d) The Act in its complained of provisions is unconstitutional and invalid in that it is "arbitrary and capricious so as to amount to confiscation and thereby offend the 5th Amendment" by its imposition of a tax upon a corporation which is without income in a business sense, as where such corporation sustains (in the taxable year) a nondeductible capital loss in excess of its "taxable net gain," or in the alternate penalizes a corporation for failing to do the impossible, viz., the payment of a dividend with nothing on hand out of which to make such payment.

In support of this contention we wish to quote for *purposes of analogy* from Mr. Justice McReynolds' opinion in *Nichols* v. *Coolidge*, 274 U. S. 531, 47 Sup. Ct. Rep. 710, 71 L. ed. 1192, 6 Amer. Fed. Tax Rep. 6758, as follows:

> "Certainly, Congress may lay an excise upon the transfer of property by death reckoned upon the value of the interest which passes thereby. But under the mere guise of reaching something within its powers Congress may not lay a charge upon what is be-

yond them. Taxes are very real things and statutes imposing them are estimated by practical results.

"As the executors paid the contested charge out of property which actually passed by death, only their rights are here involved. If the fund held by them had been insufficient and payment had been exacted from others somewhat different questions might require consideration. Lewellyn v. Frick, supra.

"The statute requires the executors to pay an excise ostensibly laid upon transfer of property by death from Mrs. Coolidge to them but reckoned upon its value plus the value of other property conveyed before the enactment in entire good faith and without contemplation of death. Is the statute, thus construed, within the power of Congress?

"Undoubtedly, Congress may require that property subsequently transferred in contemplation of death be treated as part of the estate for purposes of taxation. This is necessary to prevent evasion and give practical effect to the exercise of admitted power, but the right is limited by the necessity.

"Under the theory advanced for the United States, the arbitrary, whimsical and burdensome character of the hallenged tax is plain enough. An excise is prescribed, but the amount of it is made to depend upon past lawful transactions, not testamentary in character and beyond recall. Property of small value transferred before death may have become immensely valuable, and the estate tax, swollen by this, may leave nothing for distribution. Real estate transferred years ago, when of small value, may be worth an enormous sum at the death. If the deceased leaves no estate there can be no tax; if, on the other hand he leaves ten dollars both that and the real estate become liable. Different estates must bear disproportionate burdens determined by what the deceased did one or twenty years before he died. See Frew v. Bowers, (C. C. A. 2d) 12 F. (2d) 625.

"This court has recognized that a statute purporting to tax may be so arbitrary and capricious as

> to amount to confiscation and offend the 5th Amendment. Brushaber v. Union P. R. Co., 240 U. S. 1, 24, 60 L. ed. 493, 504, L. R. A. 1917D, 414, 36 Sup. Ct. Rep. 236, Ann. Cas. 1917B, 713; Barclay & Co. v. Edwards, 267 U. S. 442, 450, 69 L. ed. 703, 706, 45 Sup. Ct. Rep. 348. See also Knowlton v. Moore, 178 U. S. 41, 77, 44 L. ed. 969, 984, 20 Sup. Ct. Rep. 747. And we must conclude that sec. 402(c) of the statute here under consideration, in so far as it requires that there shall be included in the gross estate the value of property transferred by a decedent prior to its passage merely because the conveyance was intended to take effect in possession or enjoyment at or after his death, is arbitrary, capricious and amounts to confiscation."

Of further *important* significance in this connection is the opinion of Mr. Justice Sutherland in *Heiner* v. *Donnan,* 285 U. S. 312, 351, 76 Law. ed. 772, which reached the Supreme Court upon *certificate* (in conformity with Sec. 346, title 28, Judicial Code, U. S. C. A.) from the Circuit Court of Appeals for the Third Circuit, *for the opinion* of the Supreme Court of the United States as to whether certain provisions of the statute (then before that circuit for construction) *violated* the due process clause of the Fifth Amendment, which question when answered was answered in the affirmative.

A brief quotation from Mr. Justice Sutherland's opinion in the *Donnan* case will suffice to support the rule announced in *Nichols* v. *Coolidge, supra.* We quote:

> "That a federal statute passed under the taxing power may be so *arbitrary* and *capricious* as to cause it to fall before the due process of law clause of the 5th Amendment is settled."
>
> —*Nichols* v. *Coolidge,* 274 U. S. 531, 71 L. ed. 1184, 52 A. L. R. 1081, 47 Sup. Ct. Rep. 710;
>
> *Brushaber* v. *Union Pac. R. Co.,* 240 U. S. 1, 60 L. ed. 493, 36 Sup. Ct. R. 236;
>
> *Tyler* v. *U. S., supra,* 281 U. S. 504, 74 Law. ed.

Mr. Justice Sutherland then proceeds to quote from *Hoeper* v. *Tax Commission*, 284 U. S. 206, 76 L. ed. 251, 52 Sup. Ct. R. 120, which suggests a further quotation from the opinion of Mr. Justice Roberts in that case as follows:

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"Since, then, in law and in fact, the wife's income is in the fullest degree her separate property and in no sense that of her husband, the question presented is whether the state has power by an income-tax law to measure his tax, not by his own income, but, in part, by that of another. To the problem thus stated, what was said in *Knowlton* v. *Moore*, 178 U. S. 41, 77 44 L. ed. 969, 984, 20 S. Ct. 747, is apposite:

> 'It may be doubted by some, aside from express constitutional restrictions, whether the taxation by Congress of the property of one person, accompanied with an arbitrary provision that the rate of tax shall be fixed with reference to the sum of the property of another, thus bringing about the profound inequality which we have noticed, would not transcend the limitations arising from those fundamental conceptions of free government which underlie all constitutional systems.'

"We have no doubt that, because of the fundamental conceptions which underlie our system, any attempt by a state to measure the tax on one person's property or income by reference to the property or income of another is contrary to due process of law as guaranteed by the 14th Amendment. That which is not in fact the taxpayer's income cannot be made such by calling it income. (Compare *Nichols* v. *Coolidge*, 274 U. S. 531, 540, 71 L. ed. 1184, 1192, 52 A. L. R. 1081, 47 S. Ct. 710.)

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"It is incorrect to say that the provision of the Wisconsin income tax statute retains or reestablishes what was formerly an incident of the marriage relation. Wisconsin has not made the property of the wife that of her husband nor has it made the income from

her property the income of her husband. Nor has it established joint ownership. The effort to tax B for A's property or income does not make B the owner of that property or income, and whether the state has power to effect such a change of ownership in a particular case is wholly irrelevant when no such effort has been made. Under the law of Wisconsin the income of the wife does not at any moment or to any extent become the property of the husband. He never has any title to it, or controls any part of it. That income remains hers until the tax is paid, and what is left continues to be hers after that payment. The state merely levies a tax upon it. What Wisconsin has done is to tax as a joint income that which under its law is owned separately and thus to secure a higher tax than would be the sum of the taxes on the separate incomes.

"The court below assigned two reasons which it thought removed the constitutional objections to the application of the statute in the instant case. It cited and followed the *Income Tax Cases,* 148 Wis. 456, L. R. A. 1915B, 569, 134 N. W. 673, 135 N. W. 164, Ann. Cas. 1916A, 1147, where the statute here in question was sustained on the ground that the provisions under attack are necessary to prevent frauds and evasions of the tax by married persons, and stated that the decision of this court in *Schlesinger* v. *Wisconsin,* 270 U. S. 230, 70 L. ed. 557, 43 A. L. R. 1224, 46 S. Ct. 260, was not inconsistent with the views expressed by the Supreme Court of Wisconsin in its earlier decision. To this we cannot agree. In the *Schlesinger* case this court held invalid a statute which, for purposes of inheritance tax, classified all gifts *inter vivos,* effective within six years of death, as gifts made in contemplation of death. To the argument of the ne-

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cessity for such classification to prevent frauds and evasions, it was answered:

> 'That is to say, "A" may be required to submit to an exactment forbidden by the Constitution if this seems necessary in order to enable the State readily to collect lawful charges against

"B." Rights guaranteed by the federal Constitution are not to be so lightly treated; they are superior to this supposed necessity. The State is forbidden to deny due process of law or the equal protection of the laws for any purpose whatsoever.'

"The claimed necessity cannot justify the otherwise unconstitutional exaction.

"The second reason assigned as a justification for the imposition of the tax is that it is a regulation of marriage. It is said that the marital relation has always been a matter of concern to the state, and has properly been the subject of legislation which classified it as a distinct subject of regulation. It is suggested that a difference of treatment of married as compared with single persons in the amount of tax imposed may be due to the greater and different privileges enjoyed by the former, and, if so, the discrimination would have a reasonable basis, and constitute permissible classification. This view overlooks several important considerations. In the first place, as is pointed out above, the state has, except in its purely social aspects, taken from the marriage status all the elements which differentiate it from that of the single person. In property, business and economic relations they are the same. It can hardly be claimed that a mere difference in social relations so alters the taxable status of one receiving income as to justify a different measure for the tax.

"Again, it is clear that the law is a revenue measure, and not one imposing regulatory taxes. It levies a tax on 'every person residing within the state' and defines the word 'person' as including 'natural persons, fiduciaries and corporations' and corporations as including 'corporations, (218) joint stock companies, associations or common law trusts.' It lays graduated taxes on the incomes of natural persons and corporations at different rates. It is comprehensive in its provisions regarding gross income and allowable deductions and exemptions, and is in most respects the analogue of the federal income tax acts in force

since 1916. It is obvious that the act does not purport to regulate the status or relationships of any person, natural or artificial. *Arbitrary and discriminatory provisions contained in it cannot be justified by calling them special regulations of the persons or relationships which are the object of the discrimination.* The present case does not fall within the principle that where the legislature, in prohibiting a traffic or transaction as being against the policy of the state, makes a classification, reasonable in itself, its power so to do is not to be denied simply because some innocent article comes within the proscribed class. *Purity Extract Co.* v. *Lynch*, 226 U. S. 192, 204, 57 L. ed. 184, 188, 33 S. Ct. 44. Taxing one person for the property of another is a different matter. There is no room for the suggestion that *qua* the appellant and those similarly situated the act is a reasonable regulation, rather than a tax law.

"Neither of the reasons advanced in support of the validity of the statute as applied to the appellant justifies the resulting discrimination. The exaction is arbitrary and is a denial of due process." (Italics ours.)

We quote (in this connection) from the language of Chief Justice Taft in the *Child Labor Tax case*, 259 U. S. 39, 66 L. ed. 820, 42 Sup. Ct. R. 449, 21 A. L. R. 1432:

"* * * The congressional power over interstate commerce is, within its proper scope, just as complete and unlimited as the congressional power to tax; and the legislative motive in its exercise is just as free from judicial suspicion and inquiry. Yet when Congress threatened to stop interstate commerce in ordinary and necessary commodities, unobjectionable as subjects of transportation, and to deny the same to the people of a state, in order to coerce them into compliance with Congress's regulation of state concerns, the court said this was not in fact regulation of interstate commerce, but rather that of state concerns, and was invalid. So here the so-called tax is a penalty to coerce people of a state to act as Congress wishes

them to act in respect of a matter completely the business of the state government under the Federal Constitution. This case requires, as did the *Dagenhart* Case, the application of the principle announced by Chief Justice Marshall in *McCulloch* v. *Maryland,* 4 Wheat. 316, 423, 4 L. ed. 579, 605, in a much-quoted passage:

> 'Should Congress, in the execution of its powers, adopt measures which are prohibited by the Constitution, or should Congress, under the pretext of executing its powers, pass laws for the accomplishment of objects not intrusted to the government, it would become the painful duty of this tribunal, should a case requiring such a decision come before it, to say that such an act was not the law of the land'."

In the *Peppers Gasoline Company's* case, *supra,* page 54, contracts were entered into in writing for construction costs, before the matter of the complained of legislation was submitted to Congress by the President.

In the *Northwest Steel Rolling Mills Company's* case, the Board of Tax Appeals found (unpublished memorandum opinion) that when

> "* * * petitioner proposed to renew the notes evidencing this indebtedness (in the sum of $150,000.00) in January, 1934, the officer of the bank who was handling this matter stated to the officers of petitioner that a condition of the renewal of these notes would be a payment by petitioner of $1,000 a month in reduction of the principal amount of the indebtedness, *together with the payment on this indebtedness of any available surplus in the treasury of petitioner after the payment of its current operating expenses. Petitioner was given to understand by the officer of the bank in the course of these conversations that in case of a breach of this condition by petitioner the bank would apply for the appointment of a receiver for petitioner's assets.* This condition to the renewal of these notes was not reduced to writing and no written

contract was ever executed by petitioner which dealt with the payment of dividends. From January, 1934, to July, 1936, the amount of petitioner's indebtedness to the bank was reduced to the sum of $85,000, and this amount was paid on July 6, 1936."

Clearly such bona fide transactions come within the rule announced in *Untermyer* v. *Anderson,* 276 U. S. 445, 72 L. ed. 647, 48 Sup. Ct. Rep. 353. We quote from that decision:

"The questions now presented for consideration are similar to those involved in *Blodgett* v. *Holden,* 275 U. S. 142, *ante,* 206, 48 Sup. Ct. Rep. 105.

"The two causes differ in this: Blodgett's gifts were made during January, 1924, before the provisions for taxing such transfers were presented for the consideration of Congress; Untermyer made his gift May 23, 1924, some three months after those provisions were first presented and while the conference report upon the bill was pending. This report went to the Senate May 22, 1924, and three days thereafter the bill had finally passed both houses. The President approved it on June 2, 1924.

"Unless the difference in circumstances stated is material, the same rule of law must govern both cases.

"Two opinions were announced in *Blodgett* v. *Holden.* The one prepared by the present writer expressed the views of four of the eight justices who participated in the consideration of the cause. After quoting the pertinent provisions of the statute, etc., the opinion declared: 'So far as the Revenue Act of 1924 undertakes to impose a tax because of the gifts made during January, 1924, it is arbitrary and invalid under the due process clause of the 5th Amendment.' We need not now further repeat what was there set out.

"In the light of arguments advanced by counsel in the present cause the matter has been considered by all members of the court and a majority of them are of opinion that the gift tax provisions of the Act of 1924 here challenged must be construed as appli-

cable to gifts made during the entire calendar year 1924. And, further, *that so far as applicable to bona fide gifts not made in anticipation of death and fully consummated prior to June 2, 1924, those provisions are arbitrary and invalid under the due process clause of the 5th Amendment.*

"The mere fact that a gift was made while the bill containing the questioned provisions was in the last stage of progress through Congress we think is not enough to differentiate this cause from the former one and to relieve the legislation of the arbitrary character there ascribed to it. To accept the contrary view would produce insuperable difficulties touching interpretation and practical application of the statute and render impossible proper understanding of the burden intended to be imposed. The taxpayer may justly demand to know when and how he becomes liable for taxes—he cannot foresee and ought not to be required to guess the outcome of pending measures. The future of every bill while before Congress is necessarily uncertain. The will of the lawmakers is not definitely expressed until final action thereon has been taken."

The *four canons* of taxation laid down by Adam Smith in his "Wealth of Nations" are,

(1) equality in distribution,

(2) certainty in amount,

(3) convenience in payment,

and,

(4) economy in collection.

Disregard for the first and second of these basic requirements brings about violation of the revenue and taxation provisions of the Federal Constitution.

The refusal to respect the third and fourth of such requirements brings about the collapse of social structure.

An enlightening consideration of present day tendencies in legislation in their relation to experience in ancient times in these respects, is given in the presidential address of Ar-

thur E. R. Boak before the Michigan Academy of Science, Arts and Letters in Ann Arbor on March 17, last. We print that address as Exhibit "D" in Appendix filed herewith.

Its conclusions are obvious and its citation is not intended as an argument for the exercise of "judicial suspicion or inquiry" into legislative motive for the passage of the complained of statute.

The rules of constitutional interpretation of revenue and taxation legislation which have been consistently adhered to by this Honorable Court, indicate the importance of its context.

While *amici curiae* support the petition for writ of *certiorari,* we do not support the whole of its reasoning. We do not believe the statement (page 11) that,

> "The construction of the court below imputes to Congress an intent to make an indefensible discrimination by allowing rich corporations to avoid the tax while affording no escape to those in failing circumstances, etc.",

is well founded.

The capricious and arbitrary faults in the statutes are not founded upon one's financial condition, but (rich or poor) upon one's ability to read the stars by having in possession a contract executed with creditors (prior to May 1, 1936) in the preparation of which sufficient foresight was employed to have had written the unique guaranty "*that a dividend would not be declared or paid.*"

Whatever else the corporation might anticipate as necessary for exemption allowance under a statute which also had to be anticipated, the failure to have the provision *written into* a contract with creditors that "*dividends would not be paid*", would be fatal to the allowance of exemption which otherwise would go to one successful in guessing just what Congress would grant as its saving grace.

Such requirement could not be more capricious.

See Appendix Exhibit "E" in which are reprinted for comparison purposes sections 14, 26, 27, 102, 115, 117 and 351, of the Revenue Act of 1936, being the provisions of the Act relating to the questions involved herein.

Upon the objection that the act is "abitrary and capricious", in that it undertakes to impose a tax upon a corporation which is without income in a business sense, as where such corporation sustains (in the taxable year) a "non-deductible capital loss" in excess of its "taxable net gain", we think it important to say that such situation cannot be minimized in determining the constitutionality of the complained of statute.

If we assume that an oil or gas mining company should buy a potentially valuable lease in January for $100,000.00—which investment in such lease would be a capital asset under the provisions of section 117 of the Revenue Act of 1936, and by September of the same year exploration has proven the lease of little value and the company then sells (the lease) for $5,000.00, sustaining a $95,000.00 capital loss, the deduction for such loss against other income is limited by section 117 of the Act to the maximum of $2,000.00.

If during the year the same company has realized a net income (as defined by the statute) of $50,000.00 from operations, it has in fact lost $45,000.00 in its complete operations; but under the provisions of the complained of law it must (if in possession of as much as $93,000.00 earnings or profits accumulated in prior years) distribute $48,000.00 or pay a surtax of $9,840.00 *out of a deficit sustained* during such year, and if without sufficient earned surplus to make such distribution, must pay the surtax of $9,840.00 notwithstanding.

Of outstanding significance is the fact that *penalties* imposed by sections 102 (relating to surplus which is said to have been accumulated beyond the needs of the business) and by 351 (the creation of a personal holding company to avoid the collection of surtaxes) are not calculated or imposed until after

allowances (within the provisions of section 102(c)(1)(C) and within the like provisions of section 351(b)(3)(C)) have been made for such capital losses, whereas such *deductions* regardless of the *extent* thereof, are not permitted beyond the allowance of $2,000.00 under section 14, which *arbitrary and capricious formula* discriminatorily affects every operating corporation which respects the fiscal policy of the government in favor of those corporations engaged in an effort to nullify or defeat the fiscal policy of the government.

In other words—all capital losses are deductible under the penalty sections 102 and 351, but limited to an arbitrary deduction of $2,000.00 only (regardless of actual loss) under section 14, affecting ordinary business operation or all operating companies throughout the country.

Such denial of actual operating losses, before calculation of a so-called surtax, violates the 5th Amendment unquestionably.

In this connection we quote from 1938 Cumulative Supplement, The Law of Federal Income Taxation, by Paul & Mertens (pages 314, 315), section 32A.27:

§32A.27.—The Effect of Capital Losses.

A question of importance in connection with the dividends paid credit is whether the capital loss limitation of $2,000, which is continued in the 1936 Act[36] applies to the income subject to undistributed profits surtax. Under the capital loss limitation losses from sales or exchanges of capital assets are allowed only to the extent of $2,000, plus the gains from such sales or exchanges. Under this provision a corporation might have a substan-

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Note 36. 1936 Act, Sec. 117 (d). See Ch. 19 as to this provision.

On this subject see also Fernald, The Tax on Undistributed Profits Imposed by the Revenue Act of 1936, 7 The New York Certified Public Accountant 22, 31 (1936).

The situation discussed in this section has been mentioned as illustrative of the harshness of the undistributed profits surtax and has a possible bearing upon its constitutionality; Hendricks, The Surtax on Undistributed Profits of Corporations, 46 Yale L. J. 19, 49 (1936).

tial net income without having any earnings or profits as a source of distribution of taxable dividends. Dividends[37] are defined as any distribution made by a corporation to its shareholders, (1) out of the earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year) without regard to the amount of the earnings or profits at the time the distribution was made. The term "earnings or profits" is not the same as the term "net income,"[38] and a capital loss would affect the computation of "earnings or profits" without being deductible in computing net income. We have in these statutory provisions the possibility of corporate distributions which would not be taxable to the distributee and not, therefore, a good dividends paid credit, although the corporation might have distributed all its current earnings. For instance, a corporation without any previously accumulated earnings or profits, having an ordinary net income of $1,000,000 might have capital losses of $2,000,000. Its earnings or profits account would be $1,000,000 in the red, so that any distribution it made would not be taxable within the meaning of the Act. In such a case the "taxable net income", diminished by the normal tax and the credits provided, would be subject to the undistributed profits surtax, even if distributed, the distribution would not constitute a dividends paid credit.[38a]

Clearly such criticism of the statute in its actual workings is justified, and reveals an *arbitrary standard* that amounts to a deprivation of due process of law and property rights within the prohibitions of the 5th Amendment.

Note 37. 1936 Act, Sec. 115 (a). See § 8.02 Supplement.

Note 38. See Charles F. Ayer, 12 BTA 284; Ida I. McKinney, 32 BTA 450, 454, aff'd in Comm. v. McKinney, 87 F. (2d) 811 (C. C. A. 10th, 1937). See also § 8.37, et seq., particularly § 8.40.

Note 38a. The converse of this example is presented by a case in which the net income is $1,000,000, but earnings are $2,000,000, the difference being "velvet" depletion (the excess of percentage depletion over cost depletion—see § 8.58, Ch. 21). The distribution of $2,000,000

It has been said that the act complained of was hurriedly drawn, and such "arbitrary and capricious" provisions as have been pointed out in the many cases that have arisen over the country, indicate the warrant for that criticism.

This consideration brings to attention the further serious objection; *viz.*, the requirement (to avoid a staggering penalty) of the payment of a "dividend" with nothing on hand out of which to make such payment. A requirement upon the part of the corporation to do the impossible is certainly "arbitrary and capricious", and the Revenue Act of 1936 in its provisions with regard to such unreasonable requirement goes further in "arbitrary and capricious" requirement than any prior statute that has reached this court for interpretation.

The objections to these provisions of the Revenue Act of 1936 are so basic and fundamental as to warrant grave concern in the event of the refusal of this court to review their constitutionality.

It is therefore respectfully urged that this Honorable Court grant its writ of *certiorari*, that it may proceed to review the entire question involved and to thereafter declare and

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would do the corporation no good unless it may carry over the excess. It should be permitted to do so. See § 32A.32.

In some cases all of the earnings may be distributed, e. g., in redemption of corporate obligations previously issued, and no credit would be allowed.

In the Report of the Committee on Federal Taxation to the American Institute of Accountants (submitted September 23, 1937), it is suggested that the discrepancy between *actual* income and *taxable* income, resulting from the limitation of capital losses to $2,000 under Sec. 117 (d) may result in hardship in the application of the undistributed profits surtax, because a corporation might have a large ordinary income which was completely offset by a large capital loss, which would be deductible only to the extent of $2,000 in determining taxable income. It is recommended that this hardship be eliminated by permitting a deduction of the whole amount of the otherwise limited capital loss in computing the "adjusted net income" similar to the provision permitting such a deduction in computing the "special adjusted net income" for the purpose of applying the provision respecting improper accumulation of surplus in Sec. 102.

determine the complained of provisions of the 1936 Revenue Act void and without constitutional authority for the reasons hereinbefore and in the petition for the writ more fully set forth.

HARRY O. GLASSER,
ROBERT L. JUDD,
W. S. GREATHOUSE,
Amici Curiae.

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CHARLES ELMORE CROPLEY
CLERK

Supreme Court of the United States

October Term, 1939.

No. [redacted] 8

CRANE-JOHNSON COMPANY, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE,

APPENDIX

TO BRIEF *AMICI CURIAE* IN SUPPORT OF PETITION FOR WRIT OF *CERTIORARI*.

HARRY O. GLASSER,
805 Broadway Tower,
Enid, Oklahoma,
ROBERT L. JUDD,
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W. S. GREATHOUSE,
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Amici Curiae.

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APPENDIX.

EXHIBIT "A."

IN THE DISTRICT COURT OF THE UNITED STATES,
IN AND FOR THE DISTRICT OF UTAH
Central Division

Civil No. 84
COMPLAINT

UTAH HOTEL COMPANY, a Corporation,
Plaintiff,
vs.
IRA N. HINCKLEY, Collector of Internal Revenue, District of Utah, Defendant.

Comes now the plaintiff above named and for cause of action against the defendant alleges:

1. That plaintiff now is, and at all times hereinafter mentioned has been, a corporation organized and existing under and by virtue of the laws of the State of Utah, with its principal place of business at Salt Lake City, Utah.

2. That defendant now is, and at all times hereinafter mentioned has been, the duly appointed, qualified and acting Collector of Internal Revenue in and for the District of Utah, and as such officer of the United States now occupies and executes the duties of said office.

3. That the claim here sued upon arises under the laws of the United States and especially under Sections 14 and 26 of the Federal Revenue Act of 1936, approved June 22, 1936, and also under the Constitution of the United States and the amendments thereto.

4. That on or about March 15, 1937, under the Act of Congress approved June 22, 1936, and known as the Revenue

Act of 1936, the plaintiff filed with defendant its corporation income and excess profits tax return showing taxes as follows:

Excess profits tax	None
Normal income tax	$12,440.15
Surtax on undistributed profits	16,199.99
Total	$28,640.14

5. That said normal tax was paid in installments on the following dates, to-wit:

March 15, 1937	$ 3,110.04
June 15, 1937	3,110.04
September 7, 1937	6,220.07
Total	$12,440.15

which said tax was lawful and no claim was made for any refund.

6. That said surtax on undistributed profits, as defined in Section 14, with credits allowed as provided by Section 26, both in the Revenue Act of 1936, was paid involuntarily and under protest in installments on the following dates, to-wit:

March 15, 1937	$ 4,050.00
June 15, 1937	4,050.00
September 7, 1937	8,099.99
Total	$16,199.99

7. That as a result of an examination of plaintiff's books and records by a Federal Internal Revenue Agent an additional income tax was proposed for assessment for the year 1936 as follows:

Normal income tax	$ 280.21
Surtax on undistributed profits	325.53
Total	$ 605.74

and that such additional tax as proposed by the Federal Revenue Agent was paid under date of July 15, 1938, as follows:

Tax paid which was lawful and for which no claim for refund has been made:

Additional normal income tax	$280.21
Interest from March 15, 1937, to July 15, 1938, at 6% per annum	22.42
Total	$302.63

Amount paid involuntarily and under protest:

Additional surtax on undistributed profits.	$396.58
Interest at 6% per annum from March 15, 1938, to July 15, 1938	7.93
Total	$404.51

8. That claims for refund have been made and filed by plaintiff with the Collector of Internal Revenue for refund of all sums paid as taxes under protest, which represented the surtax on undistributed profits, as follows:

On or about July 15, 1937	$ 8,100.00
On or about September 15, 1937	16,199.99
On or about July 15, 1938	16,525.52

said claims representing the full amount of surtax on undistributed profits for the year 1936 which had been paid by the plaintiff up to and including the date on which said claims were filed; that up to and including the date on which the claim for $8,100.00 was filed, two installments of the tax disclosed by the original return filed had been paid and the claim therefor was limited to the sum of these two installments, or $8,100.00; that by September 15, 1937, the entire surtax on undistributed profits had been paid and claim therefor was made for the full amount of the surtax on undistributed profits disclosed by the original return filed in the sum of $16,199.99, which sum and claim is exclusive of the first claim amounting to the sum of $8,100.00; that after the payment of the additional tax disclosed by the Federal Revenue Agent's report resulting in an additional surtax on undistributed profits of $325.53, claim was made for the sum of $16,525.52, which claim is inclusive of the first two claims and includes the total surtax on undistributed profits for the year 1936.

9. That all three of the claims for refund heretofore described were disallowed by the Commissioner of Internal Revenue and official notice given plaintiff by registered letter dated the 9th day of December, 1938, a copy of the official notice of disallowance being hereto attached, marked Exhibit "A", and made a part of this complaint as fully as though set out in detail herein.

10. That all of the surtax on undistributed profits, and the whole thereof, was assessed and collected by the defendant erroneously, illegally and wrongfully in that:

(a) The Revenue Act of 1936 imposes a surtax on undistributed net income as defined in section 14 of said Revenue Act, which undistributed net income is calculated, after deducting as credits, dividends paid during the year and also a credit for contracts restricting the payment of dividends, as provided in Section 26(c)-1 of said Revenue Act.

(b) That in spite of the claims for refund already made no credit has been given the plaintiff for contracts restricting the payment of dividends as provided in Section 26(c)-1 of said Revenue Act, which if given would result in its having no undistributed net income and consequently no surtax on undistributed profits.

11. That in particular the Revenue Act of 1936 under Section 26(c)-1 permits credit to be taken against the calculation of undistributed net income for contracts restricting the payment of dividends, and reads as follows:

> "(c) *Contracts Restricting Payment of Dividends.* (1) Prohibition on Payment of Dividends.—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract

provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account."

12. That under date of May 20, 1909, the plaintiff was duly incorporated under the laws of the State of Utah having prior thereto filed with the Secretary of State for the State of Utah its articles of incorporation, since which date it has continued to be and at the present time is a corporation authorized to do business in the State of Utah under the provisions of said articles of incorporation.

13. That as a corporation under the laws of the State of Utah the plaintiff is subject to the laws of the State of Utah.

14. That under the law and ordinary business rules the plaintiff would have been able to pay dividends as evidenced by the following provisions of the laws of the State of Utah:

Section 18-2-16 RSU 1933—Powers of Corporations for Pecuniary Profit.

"The corporation in its name shall have power:

(1) To make all contracts necessary and proper to effect its purposes and conduct its authorized business.

(4) To disburse out of profits actually earned and on hand such dividends from time to time as the directors may deem prudent."

15. That the net earnings for the year 1936 of the plaintiff amounted to the sum of $64,541.78 from which the plaintiff was prohibited from declaring or paying any dividends by the following provisions of the laws of the State of Utah:

Section 18-2-17 RSU 1933—Dividends—Distribution of Capital Forbidden.

"No corporation shall make or pay any dividend except from the surplus profits arising from the business of the corporation and in the cases and manner allowed by law; nor divide, withdraw,

or in any manner except as provided by law pay to the stockholders or any of them, any part of the capital of the corporation."

Section 103-12-4 RSU 1933—Certain Acts Prohibited —By Directors.

"Every director of any stock corporation who concurs in any vote or act of the directors of such corporation or any of them, by which it is intended either:

(1) To make any dividend except from the surplus profits arising from the business of the corporation, and in the cases and manner allowed by law; or,

(2) To divide, withdraw or in any manner, except as provided by law, pay to the stockholders, or any of them, any part of the capital of the corporation;—is guilty of a misdemeanor.

Section 103-1-13 RSU 1933—"Felony," "Misdemeanor" Defined.

"A felony is a crime which is or may be punishable with death, or by imprisonment in the state prison. Every other crime is a misdemeanor."

Section 103-1-16 RSU 1933—Punishments for Misdemeanor.

"Except in cases where a different punishment is prescribed by law, every offense declared to be a misdemeanor is punishable by imprisonment in a county jail not exceeding six months or by a fine in any sum less than $300, or by both. In all cases where a corporation is convicted of an offense for the commission of which a natural person would be punishable as for a misdemeanor and there is no other punishment prescribed by law, such corporation is punishable by a fine not exceeding $1,000."

16. That as of December 31, 1935, the plaintiff's capital stock outstanding, consisting of 10,040 shares of the par value of $100.00 per share, was impaired to the extent of $217,699.01. This impairment of capital stock represented the accumulated deficit from operations of the corporation from January 1, 1932, to and including December 31, 1935. During the year 1936 its operating deficit was reduced by the sum of $64,541.78 representing the net earnings for the year 1936, but even after crediting said deficit with the 1936 earnings a deficit still remained amounting to the sum of $153,157.23, in consequence of which the plaintiff was prohibited by the statutes of the State of Utah from paying any dividends during that year.

17. That under Section 26(c)-1 of the Revenue Act of 1936 the plaintiff is entitled as a credit against its undistributed net income for an amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating the provisions of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends, and that its articles of incorporation duly filed prior to May 1, 1936, and the laws of the State of Utah in effect prior to May 1, 1936, together constitute a written contract, and that portion thereof comprising the laws of the State of Utah expressly deals with the payment of dividends, and that in view of the plaintiff's operating deficit at the beginning of the year and at all times during the year, even after reducing said operating deficit by the amount of the 1936 net income, said deficit still existed and the plaintiff therefore could not pay dividends during the year 1936 without violating the provisions of said contract.

18. That the amount of said credit allowed to plaintiff according to Section 26(c)-1 should be calculated as the excess of the adjusted net income over the aggregate of the amounts which can be distributed without violating the provisions of the contract, and that said credit should be calculated as follows:

Undistributed net income	$80,612.88
Aggregate amount of dividends which could be distributed within the taxable year	

without violating the provisions of the written contract heretofore referred to.. None

Amount of Credit.....$80,612.88

That after allowance of the above credit of $80,612.88 the surtax on undistributed profits, calculated as $16,525.52 on the undistributed net income before said credit would amount to zero.

19. That unless Sections 14 and 26 are so interpreted as to give credit to this plaintiff in determining its undistributed net income under the contract restricting payment of dividends as evidenced by its charter and the laws of the State of Utah, as set out in paragraphs 14 and 15 thereof, then said sections, and each of them, are unconstitutional in that:

(a) Said sections above named thereby nullify and render void and of no effect the laws of the State of Utah since said laws under said interpretation cannot be considered with and as a part of the written charter of plaintiff, which together constitute a written contract restricting the payment of dividends by plaintiff, which contract was executed prior to May 1, 1936.

(b) Said sections are, and each of them is, arbitrary, discriminatory and in conflict with the Fifth Amendment to the Constitution of the United States since said laws so interpreted allow to others than this plaintiff credit under written contracts restricting the payment of dividends, and disallow that same right to this plaintiff.

20. That since the date of said disallowance of the refund to plaintiff as demanded by it, the defendant has not paid said refund or any part thereof, so that there is now due and owing from defendant to the plaintiff the sum of $16,525.52, together with interest at six (6%) per cent per annum on the several installments collected by defendant from the date of payment of each respective installment.

WHEREFORE, plaintiff prays judgment against defendant for the sum of $16,525.52 and interest thereon at the rate of six (6%) per cent per annum from the dates of the payment of

the several installments as herein set out, or from such other date or dates as are legally allowable, together with plaintiff's costs incurred herein.

ROBERT L. JUDD,
PAUL H. RAY,
ACEL H. NEBEKER,
Attorneys for Plaintiff.
921 Kearns Building,
Salt Lake City, Utah.

Exhibit "A."

Office of Commissioner
of Internal Revenue

TREASURY DEPARTMENT
Washington

IT:C1:CC-4-CCP Dec. 9, 1938

Utah Hotel Company,
South Temple and Main Streets,
Salt Lake City, Utah.

In re: Claims for refund of $8,100.00, $16,199.99 and $16,525.52.

For the year 1936.

Sirs:

Reference is made to Bureau letter dated November 17, 1938, wherein you were informed that the claims for refund indicated above would be disallowed. The letter also stated the reasons for the proposed disallowance.

The claims having been disallowed or rejected on Schedule numbered 24530, this notice of disallowance is sent to you by registered mail as required by Section 1103 (a) of the Revenue Act of 1932.

Respectfully,

GUY T. HELVERING,
Commissioner,

By John R. Kirk,
Deputy Commissioner.

[APPENDIX—EX. A]

CERTIFICATE

STATE OF UTAH,
COUNTY OF SALT LAKE—ss.

I, W. B. WILSON, Clerk of the United States District Court in and for the District of Utah, hereby certify the foregoing and attached complaint to be a true and correct copy of the complaint on file in my office, docket number Civil 84, wherein Utah Hotel Company, a corporation, is plaintiff, and Ira N. Hinckley, Collector of Internal Revenue, District of Utah, is defendant.

I further certify that the defendant has not filed in my office up to the present time any pleading whatsoever.

IN TESTIMONY WHEREOF, I hereunto subscribe my name and affix the seal of said office in the city of Salt Lake, State of Utah, this 7th day of November, 1939.

W. B. WILSON, Clerk.

EXHIBIT "B."

UNITED STATES BOARD OF TAX APPEALS

Docket No. 96981

PEPPERS GASOLINE COMPANY, AN OKLAHOMA CORPORATION, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

PETITION

The above named petitioner hereby petitions for a review and redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency IT:E:7:8 HFS:90D dated November 7, 1938, and as a basis for this appeal alleges as follows:

1. The petitioner is a corporation duly organized under the laws of the State of Oklahoma, and for tax purposes is a citizen of the United States, with its principal place of business in room 3010 First National Bank Building, Oklahoma City, Oklahoma County, State of Oklahoma.

The return for the period here involved was filed with the Collector of Internal Revenue for the District of Oklahoma.

2. The notice of deficiency (copy of which is hereto attached marked Exhibit "A" for identification and by such reference made a part hereof) was mailed to the taxpayer on November 7, 1938.

3. The taxes in controversy are alleged to be normal income and surtax on undistributed profits taxes for the calendar year 1936, in the total sum of $36,341.68.

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) that the Congress of the United States was and is without constitutional authority to enact legislation which authorizes the Treasury Department to determine, levy and/or collect the proposed surtax on undistributed profits of the taxpayer in the year in question, *viz.*, 1936;

(b) that such surtax upon undistributed profits is not an income tax and does not come within any reasonable inclusion of authority conferred upon Congress by the 16th Amendment to the Constitution of the United States;

(c) that such surtax upon undistributed profits is a penalty placed upon the taxpayer for its failure to distribute earnings upon which all income tax otherwise legally due has been fully paid, and such penalty therefore makes unlawful distinction in classification among taxpayers, and violates the provisions of law which require uniformity in taxation;

(d) that to compel a taxpayer to distribute earnings to avoid such penalty, when debts (as here) of more than $150,000.00 (upon some of which large monthly payments are obligated by written contract) are outstanding against its business, which obligations and debts were made for betterments and improvements in such business (prior to the passage of the law requiring such distribution of earnings) denies to the taxpayer due process and the equal protection of the laws guaranteed to the taxpayer by the 5th Amendment to the Constitution of the United States;

(e) that this taxpayer had outstanding prior to May 1, 1936, valid written contracts pledging monthly payments to certain creditors of the taxpayer (from whom materials and equipment had been purchased for such betterments and improvements) which contracts could not be avoided or rescinded (true copies of which are hereto attached marked Exhibit "B" for identification and by such reference made a part hereof) and that by reason of the obligations imposed by such contracts at the respective dates of their execution, the taxpayer could not distribute earnings in violation of such obligations or assume (as is necessary in this case) a penalty of approximately 20% upon each dollar of its earnings as an additional bur-

den for its respect of such outstanding obligations, and to require the taxpayer to so perform upon the facts disclosed by these contracts, is to deprive the taxpayer of its property rights in contravention of the due process and equal protection of the laws guaranteed by the 5th Amendment to the Constitution of the United States;

(f) that the error upon the part of the Commissioner in attempting to determine, levy and collect surtax on undistributed profits, is one of law, and in which effort the Commissioner is without authority under the Constitution of the United States as hereinbefore more fully set forth; and,

(g) that such proposed surtax may be determined, levied and collected only when authorized by amendment to the present Federal Constitution.

5. That there is error in the determination of the net income in the said notice of deficiency upon which the determination of tax set forth in the said notice of deficiency is computed, in the following particulars, to-wit:

(a) The depreciation allowance made to the taxpayer upon its gasoline plant No. 4, located near Oklahoma City, Oklahoma, is made upon the application of a uniform percentage based upon an assumed useful life of eight (8) years; whereas the depreciation actually sustained should be determined in conformity with the rule stated in Art. 165, Reg. 45 (1918 Law) (restated in all subsequent regulations) and applied in *Rainbow Gasoline Corporation* v. *Commissioner,* 31 Board of Tax Appeals, page 1050, upon a unit of production method which in this case the petitioner affirms should be in that yearly proportion which the volume of gas processed in such year bears to the total volume of gas available (at the time of construction of the plant) to be ultimately processed therein.

That attached hereto and marked Exhibit "C" for identification and by such reference made a part hereof, is a statement in summary form which gives effect to the contention of the taxpayer upon depreciation allowance claimed for the year in question and in which sums so claimed its depreciation allowance should be made.

(b) That in addition to the failure of the Commissioner to allow petitioner adequate and proper depreciation, as hereinbefore set forth, the Commissioner has committed further error in requiring the petitioner during the year 1936, to capitalize $51,396.74 expended for the sole purpose of maintaining the processing capacity for which the plant was constructed and designed in order that the original investment might be returned through the period of its useful life and operative value. The petitioner complains of charges to investment while the property is becoming less valuable, with the inevitable result that when the investment is complete the property will be worthless. The petitioner therefore contends that it should be permitted to deduct as an operating expense, such amount so expended during said taxable year, notwithstanding the physical property so acquired had a useful life in excess of one year.

Wherefore, the petitioner respectfully asks that the complained of statutes (Sec. 14, Sec. 26(c) (1) and Sec. 26(c) (2), Revenue Act of 1936) which purport to authorize the determination levy and collection of surtax or surtaxes upon undistributed profits for the year or years in question, be held to be unconstitutional and that the petition be granted.

(a) depreciation allowance in conformity herewith; and,

(b) the deduction of the said $51,396.74 as an expense of maintaining the output of said plant during such taxable year; and it appearing that petitioner within three (3) years before the filing of this petition, has paid an income tax for 1936 in the total sum of $16,594.69, when under the law and facts the petitioner was not indebted in said year for Federal Income Tax in any sum whatsoever, this Honorable Board should therefore, in conformity with Section 809, Revenue Act of 1938, amending Section 322(d) of the Revenue Act of 1936, and of the Revenue Act of 1934, determine as a part of its decision that the said sum of $16,594.69 was so illegally overpaid.

Harry O. Glasser,
Attorney for Taxpayer,
805 Boardway Tower,
Enid, Oklahoma.

Approved:
Thos. F. Carey,
Oklahoma City, Oklahoma,
Auditor for Taxpayer.

State of Oklahoma,
County of Oklahoma—ss.

Charles C. Peppers being duly sworn states that he is President of the Peppers Gasoline Company, a corporation, the taxpayer named in the foregoing petition, has read the statements therein contained (and in the exhibits thereto attached) and the facts therein stated are true except such facts as are stated to be upon information and belief, and the allegations and statements so made affiant believes to be true.

Charles C. Peppers.

Subscribed and sworn to before me this 26th day of January, 1939.

Lydia Vacin,
Notary Public.

(Seal)

My commission expires June 23, 1939.

UNITED STATES BOARD OF TAX APPEALS

Washington

UNITED STATES OF AMERICA,
DISTRICT OF COLUMBIA—ss.

I, B. D. Gamble, clerk of the United States Board of Tax Appeals, hereby certify the foregoing and attached to be true and correct copies of the Petition in Docket Number 96981, wherein Peppers Gasoline Company, an Oklahoma corporation, is Petitioner and the Commissioner of Internal Revenue is Respondent.

In testimony whereof, I hereunto subscribe my name and affix the seal of said Board of Tax Appeals at the city of Washington in said District this 6th day of November, 1939.

B. D. Gamble, Clerk,
United States Board of Tax Appeals.

EXHIBIT "C."

No. 9207

IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

NORTHWEST STEEL ROLLING MILLS, INC., ***Petitioner,***

vs.

COMMISSIONER OF INTERNAL REVENUE, ***Respondent.***

Upon Petition to Review a Decision of the United States Board of Tax Appeals.

BRIEF OF PETITIONER.

EGGERMAN & ROSLING,
D. G. EGGERMAN,
WALSER S. GREATHOUSE,
Counsel for Petitioner.

1824 Exchange Building,
Seattle, Washington.

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IN THE UNITED STATES CIRCUIT COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 9207

NORTHWEST STEEL ROLLING MILLS, INC., *Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Upon Petition to Review a Decision of the United States Board of Tax Appeals.

BRIEF OF PETITIONER.

JURISDICTION.

This appeal involves a deficiency in income tax liability of petitioner for the calendar year 1936 and is from a decision of the United States Board of Tax Appeals entered February 17, 1939 (R. 18, 19), the decision being based upon the opinion of the Board disallowing petitioner a credit of $75,085.26 for contracts restricting dividend payments, which credit was claimed by petitioner in computing its surtax on undistributed profits under Sections 14 and 26 of the Revenue Act of 1936 (R. 14, 16-18). Petition had been filed with the Board of Tax Appeals for a redetermination of deficiency of income tax liability as set forth in a Notice of Deficiency from respondent Commissioner dated February 4, 1938 (R. 3-12). Respondent answered the petition, admitting that the taxes in controversy were as above indicated, and denying certain material allegations of the petition upon which petitioner sought a redetermination (R. 13). The Board of Tax Appeals had jurisdiction by virtue of Sec. 501, Revenue Act of 1934, c. 277, 48 Stat. 741, 26 USCA 272.

Findings of Fact and opinion of the Board of Tax Appeals were filed and decision was entered for respondent Commis-

sioner (R. 14-18). This appeal from the decision of the Board is pursuant to Section 1001-1003, Revenue Act, February 26, 1926, c. 27, 44 Stat. 109, 110, as amended by Sec. 1101, Revenue Act of 1932, c. 209, 47 Stat. 169, 286.

There is involved the validity of Sections 14 and 26 of the Revenue Act of 1936, pertinent provisions of which are as follows:

"Sec. 14. Surtax on Undistributed Profits.

"(a) Definition—as used in this title * * *

"(2) The term 'undistributed net income' means the adjusted net income minus the sum of the dividends paid credit provided by Section 27 and the credit provided in Section 26 (c), relating to contracts restricting dividends.

"Sec. 26. Credits of Corporations.

"In the case of a corporation, the following credits shall be allowed to the extent provided in the various sections imposing tax— * * *

"(c) Contracts restricting payment of dividends.—

"(1) Prohibition on payment of dividends.—An amount equal to the excess of the adjusted net income over the aggregate of the amount which can be distributed in the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount, only one shall be taken into account.

"(2) Disposition of profits of taxable year.—An amount equal to the portion of the earnings and profit of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year to be paid within the taxable year in discharge of a debt, or to be ir-

revocably set aside within the taxable year for the discharge of a debt); to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word 'debt' does not include a debt incurred after April 30, 1936."

STATEMENT OF THE CASE.

The questions involved are three-fold.

1. Is petitioner's corporate charter from the State of Washington, which charter was granted prior to May 1, 1936, and the general corporation law of the State of Washington, a written contract within the meaning of Section 26 of the Revenue Act of 1936, entitling petitioner to the credits allowed under that section?

2. Are Sections 14 and 26 arbitrary and discriminatory and an illegal interference by the federal government with state sovereignty if construed as disallowing a credit although petitioner's charter prohibits payment of dividends?

3. Are Sections 14 and 26 of the Revenue Act of 1936 arbitrary and discriminatory in that they deny credit to petitioner because of the provision of an *oral* contract with a creditor bank prohibiting the payment of dividends whereas they allow credit where similar provisions are contained in a *written* contract?

The Board of Tax Appeals found the following facts:

Petitioner corporation was organized in 1926 under the general corporation laws of the State of Washington and received its charter to carry on business from that state (R. 14).

Petitioner's operating deficit as of December 31, 1935, was $76,983.26. Its net income for 1936 was $76,049.71 (R. 14).

July 6, 1936, petitioner paid $85,000 to Seattle-First National Bank in retirement of its indebtedness (R. 15) evidenced by 90-day note. This indebtedness had been outstanding since

1926 (R. 14, 15) and at one time had been $150,000, subsequently reduced to $115,000, then to $85,000 (R. 15).

The Bank Examiners and the Executive Committee of the bank had criticized the amount of the loan and these criticisms had been recurrent. When the notes were renewed in January, 1934, a condition imposed by the bank on the renewal was that petitioner must pay $1,000 a month in reduction of principal *and* must pay on the indebtedness any available surplus in the treasury after payment of current operating expenses. Petitioner was given to understand that, in case of breach of this condition, the bank would apply for a receiver of petitioner's business (R. 15).

The evidence supports the above findings and also discloses some additional matters. Respondent admitted the allegation of the petition that petitioner is a corporation organized under the laws of the State of Washington (R. 3, 13). Beginning in 1926 petitioner borrowed large amounts from the Seaboard National Bank, subsequently a branch of the Seattle-First National Bank of Seattle (R. 35). From 1926 to 1936 petitioner was continuously indebted to the bank, the maximum amount of the indebtedness being $150,000 (R. 38). Before the depression petitioner had reduced the loan to $125,000. Subsequently the loan was reduced to $115,000 and stood at that figure for many years. When petitioner agreed to make $1,000 a month reduction in principal, the indebtedness stood at $115,000 (R. 38). This indebtedness was evidenced by a 90-day note which was renewed (R. 38, 39). The loan was subject of criticism by the Executive Committee of the bank and by the bank examiner from time to time (R. 39). In 1936 the bank received $1,000 a month on the indebtedness (R. 39). The bank declined to permit any additional capital outlay by the company until the indebtedness was paid (R. 40).

If petitioner had violated the bank's instructions prohibiting payment of any dividends, the bank would have put the company into receivership (R. 41). Mr. Howell of the bank had known the Goetz family for many years and relied upon what they said and believed the promises which they made on behalf of petitioner (R. 43).

Any available money in the treasury of petitioner was to be used for current operating expenses and any surplus was

to be used to repay indebtedness to the bank (R. 47). Mr. Howell repeatedly told Mr. Gotez that if there was any excess money it should be paid on the note at the bank (R. 50).

Mr. Howell also made it clear in verbal conversation with Mr. Gotez that petitioner company could not pay a dividend until the note to the bank was paid off (R. 41). The note was paid in July, 1936 (R. 41). The payment was made out of reduction of inventory (R. 50). Petitioner had never been in a position to pay the bank prior to that time. A deficit had been accumulating regularly since January 2, 1934 (R. 50, 49). It was stipulated that petitioner had an operating deficit as of December 31, 1935, of $76,983.26 (R. 71) and that the net income for the year 1936 was $76,049.71 (R. 71). *Petitioner had never been in a position to pay dividends* (R. 50).

SPECIFICATIONS OF ERROR.

1. Petitioner assigns error on the part of the United States Board of Tax Appeals in entering a decision for respondent and in deciding that petitioner was subject to any deficiency for the calendar year 1936.

2. The Board erred in determining that the charter and general corporation laws of the State of Washington are not a written contract within the meaning of Section 26 of the Revenue Act of 1936.

3. The Board erred in denying petitioner's contention that Sections 14 and 26 of the Revenue Act of 1936 are invalid and unconstitutional.

4. The Board erred in that its decision is not supported by the evidence and stipulation of facts and is contrary to law (R. 74-76, incl., 23, 24).

SUMMARY OF ARGUMENT.

1. The charter and corporation laws of the State of Washington constitute a written contract between petitioner, its stockholders, and the State of Washington. By virtue of such charter and state laws, petitioner was forbidden payment of dividends in the year 1936. It would have been an illegal act for petitioner to have distributed a dividend. Therefore, petitioner was entitled to a credit because it could not distribute within the taxable year as dividends any accumulation of earnings without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which contract expressly deals with the payment of dividends.

2. Assuming that the charter and corporation laws of the State of Washington are held not to be a written contract within the provisions of Section 26, Revenue Act of 1936, then the latter act is invalid and unconstitutional as being arbitrary, capricious and unjust and in violation of the Fifth Amendment of the Federal Constitution because it allows a credit to a corporation as to a *written* contract, but refuses such credit to a corporation that is helpless to make a distribution of dividends because of its charter and of the general corporation laws, and which, if it did make a dividend, would be doing an unlawful act. Furthermore, the Act constitutes an illegal interference by the federal government with state sovereignty, in contravention of the Tenth Amendment to the Federal Constitution in that the state has exclusive power and authority as to legislation of corporations incorporated under its jurisdiction and as to when such corporations may pay dividends, and the state has legislated in that regard. The federal legislation in this instance is an interference with the state in a sphere in which the state has sole jurisdiction.

3. There was an oral agreement with the bank prohibiting petitioner from paying dividends. It is arbitrary, unjust and an unconscionable exaction to disallow a credit to a corporation which has a binding *verbal* agreement prohibiting the payment of dividends while allowing the credit to a corporation which has a *written* agreement; and Sections 14 and 26, Revenue Act of 1936 are therefore unconstitutional and invalid.

ARGUMENT.

I.

PETITIONER WAS ENTITLED TO A CREDIT BECAUSE OF THE CHARTER AND GENERAL CORPORATION LAWS OF THE STATE PROHIBITING DISTRIBUTION OF A DIVIDEND.

Petitioner was incorporated in 1926 (Petitioner's Ex. 3; Articles of Incorporation, R. 58-66, Petitioner's Ex. 4; R. 67), "Under the general incorporation laws of the State of Washington" (R. 58), to exercise "such powers as are or may be granted or conferred by the general incorporation laws of the State of Washington * * *" (R. 63, 19th paragraph).

Thus, the Articles of Incorporation expressly refer to the general incorporation laws of the State of Washington. Those laws prior to May 1, 1936, and throughout the year 1936 provided in part as follows:

> "In computing the aggregate of the assets of the corporation, the Board of Directors shall determine and make proper allowance for depreciation and depletion sustained, and losses of every character. Deferred assets and prepaid expenses shall be written off, at least annually in proportion to their use as may be determined by the Board of Directors.
>
> "4. *No corporation shall pay dividends,*
>
> "a. In cash or property, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock, after deducting from such aggregate of its assets the amount by which such aggregate was increased by unrealized depreciation in value or revaluation of fixed assets;
>
> "b. In shares of the corporation, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock.

"5. Cash dividends shall not be paid out of surplus due to or arising from,

"a. Any profit on treasury shares before resale; or,

"b. Any unrealized profits due to increase in valuation of inventory before sale; or

"c. The unaccrued portion of unrealized profits on notes, bonds or obligations for the payment of money purchased or acquired at a discount unless such notes, bonds or obligations are readily marketable, in which case they may be taken at their actual market value; or

"d. The unaccrued or unearned portion of any unrealized profit in any form whatever, whether in form of notes, bonds, obligations for the payment of money, installment sales, credits or otherwise * * *."

Uniform Business Corporation Act, Laws of 1933, page 785, Sec. 24 of the State of Washington; Rem. Rev. Stat. 3803-24 (2, 3, 4 and 5).

"If any dividend be paid in violation of Section 3803-24, or if any other unlawful distribution, payment or return of assets be made to shareholders,

"1. The directors who knowingly, or without making reasonable inquiry, voted in favor thereof shall be jointly and severally liable to the corporation in an amount equal to the amount of the dividends so paid and the distribution, payment or return of assets so made;

"2. Every shareholder who receives any such dividend or any such distribution, payment or return of assets, shall in the following instances be individually liable to the corporation in an amount equal to the amount so received by him:

"a. When no director is liable to the corporation as provided in Subdivision 1 of this section, or

"b. To the extent that the corporation is unable to obtain satisfaction after judgment is recovered against directors upon the liability imposed by Subdivision 1 of this section * * *"

Session Laws 1933, page 787, Sec. 25, Laws of the State of Washington; Rem. Rev. Stat. 3803-25.

Dividends paid in impairment of capital are *illegal.*

Sparling, Trustee, v. *General Discount and Mortgage Corporation,* 178 Wash. 663, 670, 35 P. (2d) 60; af. on rehearing 184 Wash. 387, 50 P. (2d) 1023.

It has been the uniform rule applicable to corporations incorporated in the State of Washington that *"the corporation could only pay dividends out of profits."*

Austin v. *Wright,* 156 Wash. 24, 27, 286 Pac. 48.

"'The rule of law that requires corporations to preserve their capital intact is alone sufficient to prevent the corporation from paying dividends *except out of profits.'* 5 Thompson, Corporation, (2d ed.) Sec. 5305."

Jorguson v. *Apex Gold Mine Co.,* 74 Wash. 243, 244, 245, 133 Pac. 465, 46 L. R. A. (ns) 637.

This rule is so stringently enforced that "any contract whereby a corporation seeks to diminish its capital stock, except in some way permissible by statute, contravenes public policy and is unenforceable."

Jorguson v. *Apex Gold Mine Co.,* 74 Wash. 243, 133 Pac. 465, 46 L. R. A. (ns) 637.

Capital stock is a trust fund and cannot be impaired by distribution to stockholders.

Brenneman v. *Whitehouse,* 85 Wash. 355, 358, 359, 148 Pac. 24;

Fox v. *Seattle Contact Co.,* 98 Wash. 557, 168 Pac. 185;

Gaunce v. *Schoeder,* 145 Wash. 604, 605, 261 Pac. 393.

Petitioner had an operating deficit as of December 31, 1935, in the sum of $76,983.26 (R. 14; R. 71). The net income for the year ending December 31, 1936, is $76,049.71 (R. 14; R. 71, 72). The note to the bank in the sum of $85,000.00 was paid July 6, 1936 (R. 15; R. 41; R. 49). This payment was made out of reductions of inventories (R. 50). Petitioner had not been in a position to pay the bank prior to July 6, 1936 (R. 50). *A deficit had been accumulating for many years and petitioner has never been in a position to pay dividends* (R. 50).

Since it would have been a violation of the laws of the State of incorporation for petitioner to have paid a dividend, are such laws "a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends?" If so, then a credit is allowable under Section 26, Revenue Act of 1936.

The Articles of Incorporation were executed February 11, 1926 (Petitioner's Ex. 3; R. 58, 66). These Articles were accepted by the State of Washington March 20, 1926 (R. 67), and thereby became a binding contract in writing.

> "It (the corporate charter) is a contract between the state and the corporation and its members; between the corporation and its stockholders, and between the stockholders themselves. This is true not only of charters conferred by special act but also of those which exist under general law."
>
> Fletcher, Cyc. on Corporations, Vol. 7, Sec. 3657, pp. 792, 793, 794, and cases there cited.

This principle was established in *Trustees of Dartmouth College* v. *Woodward,* 4 Wheat. (U. S.) 518, 4 L. ed. 629, and reaffirmed in *Trustees of Jefferson College* v. *Washington & Jefferson College,* 20 L. ed. 550, 80 (U. S.) 190.

> "The articles of certificate do not alone constitute the charter, and determine the powers of the corporation *but they are to be taken in connection with the statutes.*"
>
> Fletcher Cyc. Corporations, (Perm. Edn.) Vol. 7, Ch. 42, Sec. 3635, p. 762.

The charter and by-laws of a corporation constitute a contract between the company and its stockholders *into which the statutes of the state of its incorporation enter and are controlling.*

> *Ainsworth* v. *SW Drug Corp.,* (C. C. A. 5) 95 F. (2d) 172, 173.

> "The relationship existing between a corporation and its stockholders is one of contract * * * in which the charter and by-laws of the corporation *and pertinent statutes*

of the state are embodied. (Jones v. *NW Edison Elec. Co.*, (C. C. A.), 144 Fed. 765, 770.)"

Schroeter v. *Bartlett Syndicate Bldg. Corp.*, (Cal.) 55 P. (2d) 1221.

"Where possible, we must endeavor to give effect to all provisions of the statute and certificate which are sufficiently clear and definite as to be reasonably understood and expressive of the agreement between the incorporator and between the corporation and its stockholders. *Such provisions are a constituent part of the contract entered into.*"

Yoakam v. *Providence Biltmore Hotel Co., et al.*, (D. C. R. I.) 34 F. (2d) 533, 541.

"The charter of a private corporation constitutes a contract, not only between the state and the corporation, the shareholders and the corporation, but also between the state and the shareholders. This is settled law. *Wilmington Rr.* v. *Reid*, 13 Wall. 264, 20 L. ed. 568; *Larabee* v. *Dolley*, (C. C.) 175 Fed. 365, p. 390; *Garey* v. *Mining Co.*, 32 Utah 497, 91 Pac. 369, 12 LRA (ns) 554; Cook on Corporations, (3rd ed.) Sec. 492 to 496, inclusive. *The transaction necessarily involves the assent of the shareholders.*"

Tyler v. *Dane County*, (D. C. Wisc.) 289 Fed. 843, 855, 856.

To the same effect:

Forman v. *A. B. Leach & Co., Inc.*, (D. C. N. Y.) 11 F. (2d) 454, 456;

Oregon Rr. & Nav. Co. v. *Oregonian Ry. Co.*, 130 U. S. 1, 21, 24, 25, 32 L. ed. 837, 840, 841, 842;

Republican Mountain Silver Mines, Ltd., v. *Brown*, (C. C. A. 8) 58 Fed. 644, 649, 650;

Sanderson v. *Salmon River Canal Co.*, 45 Idaho 234, 263 Pac. 32.

"Where corporations are organized under the general law, as is required in this state by Article 11, Sec. 2, of our Constitution, *the charter of a private corporation*

consists not only of the Articles of Incorporation, *but includes all general statutes applicable to that class of corporation, and all persons, whether stockholders or creditors, who have dealings with the corporation are conclusively presumed to do so with knowledge of its charter and of its charter rights* * * *."

Loveland & Co. v. *Doernbecher Mfg. Co.*, (Ore.) 39 P. (2d) 668, 673.

The Constitution of the State of Washington also requires that corporations be organized under the general law.

"Corporations may be formed under general law, but shall not be created by special act. All laws relating to corporations may be altered, amended or repealed by the Legislature at any time, and all corporations doing business in this state, may, as to such business, be regulated, limited or restrained by law."

Article 12, Sec. 1, Constitution of the State of Washington; Rem. Rev. Stat., Vol. 1, p. 479.

Thus the federal government and its agents must be *conclusively presumed* to know of the prohibitions imposed upon corporations in the State of Washington against the payment of dividends and it must be assumed that Congress likewise had knowledge of this fact and it would seem an unreasonable construction to place upon an enactment of Congress that a corporation would be allowed a credit if it paid a dividend when it had no right to do so, but would be disallowed the credit if it conformed to law which prohibited distribution of dividends. An interpretation which would place a premium on illegal acts should be avoided if consistent with a reasonable interpretation of the act.

For a general discussion of Section 26, Revenue Act of 1936, and of the legal principle that the charter is a contract, as applied to said section, see Paul & Mertens, *"Law of Federal Income Taxation,"* 1938 Cum. Supp., Vol. 3, Sec. 32-A, 43, pp. 350-354, incl.

Every element required under Section 26 for a credit exists in the instant case. No dividends could have been declared by petitioner without violating a provision of a written con-

tract (to-wit, the corporate charter which embodies the laws of the state of its incorporation) executed by the corporation prior to May 1, 1936 (the Articles of Incorporation were executed in 1926, approved by the state that year, and the corporation has proceeded pursuant to those articles ever since, the articles and state law being an executed contract not only between the state and the corporation, but also between the corporation and its stockholders, and between the stockholders and the state) which provision expressly deals with the payment of dividends (Rem. Rev. Stat. 3803-24, expressly deals with dividends and is "a constituent part of the contract entered into" as does the general law of the state as announced in court decisions).

Furthermore, there being constitutional questions raised as to the validity of the Act if such credit does not obtain, the statute should, if possible, be construed to allow the credit and thereby remove doubts as to its invalidity.

> "A statute must be construed, if fairly possible, so as to avoid not only the conclusion that it is unconstitutional, but also grave doubts upon that score, * * *."
>
> *Linder* v. *U. S.*, 69 L. ed. 819, 823, 268 U. S. 5, 17.

A construction is to be avoided which will raise a constitutional doubt and if ambiguity exists, it must be resolved in taxpayer's favor.

> *U. S.* v. *Jim Fuey Moy*, 241 U. S. 394, 401, 60 L. ed. 1061, 1064;
>
> *U. S.* v. *Havner*, (C. C. A. 8) 101 F. (2d) 161, 165.

If doubt exists as to the construction of a taxing statute the doubt should be resolved in favor of the taxpayer.

> *Hasett* v. *Welsh*, 303 U. S. 303, 314, 82 L. ed. 858, 867.

II.

THE ACT IS UNCONSTITUTIONAL UNLESS IT ALLOWS A CREDIT ARISING FROM THE CHARTER AND LAWS OF THE STATE.

"The state law makes the payment of dividends in such cases illegal and subjects the corporate officials to penalty for violation of its provisions. A strong argument may be made to the effect that the imposition of a graduated tax designed to force the commitment of illegal acts by directors of a corporation is arbitrary and unreasonable, and such a statute invades the powers reserved to the state to regulate the internal affairs of corporations * * *.

"* * * It may be that to avoid constitutional questions the credits granted by the statute to corporations having written contracts executed by the corporation prior to May 1, 1936, prohibiting the payment of dividends will, in the case of corporations organized prior to May 1, 1936, be held by the courts broad enough to cover situations in which the state law prohibits the payment of dividends."

Paul & Mertens, *"Law of Federal Income Taxation,"* Vol. 3, 1938 Cum. Supp., Sec. 32-A, 53, pp. 382, 383.

"Except insofar as they may be restrained by constitutional provisions, the legislatures of the several states, as the depositaries of the sovereign legislative power, have the inherent power to create corporations and to determine and prescribe the mode of incorporation, the purposes for which corporations shall be created, the powers which shall be conferred upon them, and the conditions under which they may be exercised."

14 C. J., "Corporations," Sec. 56, p. 94;
Briscoe v. *Ky. Bank,* 11 Pet. 257, 9 L. ed. 709;
In re Wyoming Coop. Assn., (D. C. Pa.) 198 Fed. 436.

"The general rule with regard to the respective powers of the national and the state governments under the

constitution, is not in doubt. The states were before the constitution, and, consequently, their legislative powers antedated the constitution. Those who framed and those who adopted that instrument meant to carve from the general mass of legislative powers, then possessed by the state, only such portions as it was thought wise to confer upon the federal government; and in order that there should be no uncertainty in respect of what was taken and what was left, the national powers of legislation were not aggregated but enumerated—with the result that what was not embraced by the enumeration remained vested in the states without change or impairment * * *. While the states are not sovereign in the true sense of that term, but only quasi sovereign, yet in respect of all powers reserved to them they are supreme—'as independent of the general government as that government within its sphere is independent of the state.' *Collector* v. *Day (Buffington* v. *Day)* 11 Wall. 113, 124, 20 L. ed. 122, 125. And since every addition to the national legislative power to some extent detracts from or invades the power of the state, it is of vital moment that, in order to preserve the fixed balance intended by the constitution, the powers of the general government be not so extended as to embrace any not within the express terms of the several grants or the implications necessarily to be drawn therefrom. It is no longer open to question that the general government, unlike the state, * * * possesses no *inherent* power, in respect of the internal affairs of the state; and emphatically not with regard to legislation."

Carter v. *Carter Coal Co.*, 80 L. ed. 1160, 1180, 298 U. S. 238, 294, 295.

To the same effect see:

Thurlow v. *Massachusetts*, 5 How. (U. S.) 504, 588, 12 L. ed. 256, 294;

59 C. J., "States," Sec. g, p. 20, and cases there cited;

Ex parte Guerra, (Vt.) 110 Atl. 224, 10 A. L. R. 1560;

American Coal Mining Co. v. *Special Coal, etc., Com.*, 268 Fed. 563, 565; Appeal dismissed, 258 U. S. 632, 42 Sup. Ct. 273, 66 L. ed. 801;

Central Union Tel. Co. v. *Indianapolis Tel. Co.*, (Ind.) 126 N. E. 628, 631, 632.

"No rule of law is better settled throughout the United States than that a state legislature has absolute power to enact, that is, pass, amend, or repeal, any law whatsoever it pleases, unless it is prohibited from so doing by either the state or federal constitutions; that the courts can only restrain the execution of a statute when it conflicts with either one or the other of said constitutions." *State* v. *Whisman*, (S. D.) 154 N. W. 707, 709.

To the same effect:

12 C. J., "Constitutional Law," Sec. 168, p. 749, and cases there cited;

State v. *Howell*, 85 Wash. 294, 297, 147 Pac. 1159;

Jacobson v. *Mass.*, 197 U. S. 11, 49 L. ed. 643, 649.

"A state, through its legislature, may regulate all corporations, without regard to their nature, just the same as they may regulate an individual, except in so far as the power to regulate is precluded by constitutional provisions or by provisions in the charter or franchise."

Fletcher, "Cyc. Corporations," Vol. 14, Ch. 59, Sec. 6684, p. 39.

"The power of taxation, which is expressly granted, may, of course, be adopted as a means to carry into operation another power also expressly granted. But resort to the taxing power to effectuate an end which is not legitimate, not within the scope of the constitution, is obviously inadmissible.

"'*Congress is not empowered to tax for those purposes which are within the exclusive province of the states.*' *Gibbons* v. *Ogden*, 9 Wheat. 1, 199, 6 L. ed. 23, 70."

U. S. v. *Butler*, 80 L. ed. 477, 490, 56 Sup. Ct. 312, 297 U. S. 1, 69, 102 A. L. R. 914, 927.

"'A statute must be construed, if fairly possible, so as to avoid not only the conclusion that it is unconstitutional, but also grave doubts upon that score,' * * *. Obviously, direct control of medical practice in the states is beyond the power of the federal government. Incidental

regulation of such practice by Congress through a taxing act cannot extend to matters plainly inappropriate and unnecessary to reasonable enforcement of a revenue measure. The enactment under consideration levies a tax, upheld by this court, upon every person who imports, manufactures, produces, compounds, sells, deals in, dispenses or gives away opium or cocoa leaves or derivatives therefrom, and may regulate medical practice in the states only so far as reasonably appropriate for or merely incidental to its enforcement."

"* * * The narcotic law is essentially a revenue measure, and its provisions must be reasonably applied with the primary view of enforcing the special tax. We find no facts alleged in the indictment sufficient to show that petitioner had done anything falling within definite inhibitions or sufficient materially to imperil orderly collection of revenue from sales. Federal power is delegated, and its prescribed limits must not be transcended even though the end seems desirable. The unfortunate condition of the recipient certainly created no reasonable probability that she would sell or otherwise dispose of a few tablets entrusted to her; and we cannot say that by so dispensing them, the doctor necessarily transcended the limits of that professional conduct with which Congress never intended to interfere."

Linder v. *U. S.*, 69 L. ed. 819, 823, 825, 268 U. S. 5, 17, 18, 22.

We submit that it is unconstitutional for Congress to impose drastic surtaxes for failure to distribute income which under the laws of the state a corporation is not permitted to distribute, and that this act constitutes an illegal federal interference with state power in so far as the act indirectly constitutes a regulation of corporate activity.

Furthermore, the tax is a penalty tax. The tax is not on income, but is dependent upon what the taxpayer does with its income already taxed, and therefore, the provisions are arbitrary, capricious and oppressive, and render the tax unconstitutional. The fact that Congress has failed to exempt stockholders from tax on dividends subsequently paid from profits

previously subjected to the surtax demonstrates that the tax is a penalty tax.

Montgomery, "Federal Income Tax Handbook," (1936) Ch. 20, pp. 703, 704.

III.

SECTION 26 OF THE REVENUE ACT OF 1936 IS UNCONSTITUTIONAL BECAUSE IT IS ARBITRARY AND DISCRIMINATORY, IN THAT IT PERMITS THE CREDIT AS TO A WRITTEN CONTRACT BUT DENIES A CREDIT AS TO AN ORAL CONTRACT OF THE SAME TERMS.

The primary object of the tax provisions in question was to induce the distribution of corporate surpluses as dividends to stockholders so that such dividends might be taxed.

> "The accumulation of surplus in corporations controlled by taxpayers with large incomes is encouraged by the present freedom of undistributed corporate income from surtaxes. Since stockholders are the beneficial owners of both distributed and undistributed corporate income, the aim, as a matter of fundamental equity, should be to seek equality of tax burden on all corporate income whether distributed or withheld from the beneficial owners. As the law now stands our corporate taxes dip too deeply into the shares of corporate earnings going to stockholders who need the disbursement of dividends, while the shares of stockholders who can afford to leave earnings undistributed escape current surtaxes altogether."
>
> Presidential Message, March 3, 1936; House Report No. 2475, 74th Congress, 2d Session.

> "One of the so-called social objectives of the new tax provision, according to the President, was the forcing of corporate surpluses into the hands of stockholders."
>
> Montgomery, "Federal Income Tax Handbook," (1936-1937) Ch. 20, p. 703.

There is no dispute as to the agreement with the bank and the Board found that there was an agreement whereby

petitioner was required to pay $1,000.00 a month in reduction of the principal amount of the indebtedness "together with the payment on this indebtedness of any available surplus in the treasury of petitioner after the payment of its current operating expenses." And if petitioner did not do this, the bank would apply for the appointment of a receiver for petitioner's assets (R. 15). Admittedly this agreement was made prior to May 1, 1936. It was made to preserve the very existence of petitioner corporation.

One form of contract, whether oral or in writing, whether with the state or with a private party, is as good as another, provided that in each case the agreement expressly deals with the payment of dividends.

The section imposes an unreasonable discrimination under the Fifth Amendment between corporations which are in reality in substantially the same position.

> "Where the tax is so 'arbitrary and capricious as to cause it to fall' before that clause (the Fifth Amendment) or when the classification was so arbitrary as to have no relation to any special benefits derived by a particular group or clearly discriminatory as between persons in the same category it is invalid."
>
> *Brushaber* v. *Union Pac. Rr. Co.*, 60 L. ed. 493, 240 U. S. 1;
>
> *Nichols* v. *Coolidge*, 71 L. ed. 1184, 52 A. L. R. 1081, 274 U. S. 531.

> "An excise tax which contains arbitrary and unreasonable exemptions, or which attempts to discriminate unfairly between persons who properly fall within the same class, would encounter the objection that it lacks uniformity."
>
> *Pollock* v. *Farmers Loan, etc., Co.*, 158 U. S. 600, 39 L. ed. 1108;
>
> 26 R. C. L., p. 81, "Taxation," Sec. 59.

The act seeks to limit the credit to a written contract and to deny the credit entirely to a corporation utterly powerless

to distribute dividends because of an *oral* contract admittedly in existence prior to May 1, 1936. The Revenue Act in question, of course, became the law subsequent to that date. In seeking to confine the contract to a *written* one that must have been in existence prior to the enactment of the act, and in ignoring *oral* obligations by which the corporation had become committed prior to that date, the act constitutes an unjust, arbitrary and capricious discrimination, and is unconstitutional.

CONCLUSION.

It is reasonable and just to construe the Act as including the charter and corporation laws as a written contract entitling a corporation to a credit if prohibited from distributing dividends by reason of such charter and laws. If there is any doubt as to the construction of the Act, the doubt should be resolved in favor of taxpayer under the usual rule, and further, because question is raised as to the constitutionality of the Act.

If it be held that the charter is not a written contract, then the Act is arbitrary and discriminatory and constitutes an illegal interference with the State by the Federal Government.

In any event, the Act is discriminatory and invalid in drawing a distinction between a *written* and an *oral* contract prohibiting payment of dividends.

No deficiency should be assessed petitioner.

Respectfully submitted,

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No. 9207

IN THE UNITED STATES CIRCUIT COURT OF APPEALS
FOR THE NINTH CIRCUIT.

NORTHWEST STEEL ROLLING MILLS, INC., *Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

On Petition for Review of Decision of the United States Board of Tax Appeals.

BRIEF FOR THE RESPONDENT.

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IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

No. 9207

NORTHWEST STEEL ROLLING MILLS, INC., *Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

On Petition for Review of Decision of the United States Board of Tax Appeals.

BRIEF FOR THE RESPONDENT.

Opinion Below.

The only previous opinion in this case is the memorandum opinion of the United States Board of Tax Appeals (R. 14—18) which is unreported.

Jurisdiction.

This appeal involves income taxes for the year 1936 and is taken from the decision of the Board of Tax Appeals entered February 17, 1939. (R. 18-19.) The case is brought to this Court by petition for review filed May 10, 1939 (R. 19-25), pursuant to the provisions of Sections 1141-1142 of the Internal Revenue Code.

Questions Presented.

1. Whether the evidence sustains the taxpayer's contention that it could not legally have paid dividends during the taxable year 1936.

2. Even if taxpayer could not legally have paid dividends in 1936, is it entitled to credit under Section 26 (c) (1) of the Revenue Act of 1936 on the ground that the charter and state

statutes constitute a written contract prohibiting payment of dividends?

3. Whether there are any constitutional prohibitions against denial of the claimed credit under the circumstances of this case.

Statutes and Regulations Involved.

The statutes and regulations involved are set forth in the Appendix, *infra*, pp. 30-39 [65-72].

Statement.

The facts found by the Board of Tax Apeals (R. 14—15) are substantially as follows:

The taxpayer is a corporation organized in 1926 under the laws of the State of Washington. Its principal place of business is Seattle, Washington. (R. 14.)

Taxpayer's surplus by appraisal at the beginning and end of 1936 was $134,173.90. Its operating deficit as of December 31, 1935, was $76,983.26, and its net income for the year ended December 31, 1936, was $76,049.71. From 1926 to 1936 taxpayer was indebted in considerable sums to the Seattle First National Bank, Seaboard Branch. This indebtedness was evidenced by ninety day notes which were from time to time renewed. In January, 1934, this indebtedness amounted to approximately $115,000 and when taxpayer proposed to renew the notes, the officer of the bank who was handling the matter told the taxpayer's officers that a condition of renewal would be payment of $1,000 a month in reduction of the principal amount of the indebtedness, together with payments thereon of any available surplus remaining in taxpayer's treasury after payment of its current operating expenses. Taxpayer was given to understand by the officer of the bank in the course of these conversations that in case of a breach of this condition by taxpayer the bank would apply for the appointment of a receiver. This condition to renewal of the notes was not reduced to writing and no written contract was ever executed by taxpayer which dealt with payment of dividends. From January, 1934, to July, 1936, the amount of taxpayer's indebtedness to the bank was reduced to $85,000 and this amount was paid on July 6, 1936. (R. 14—15.)

In computing its surtax on undistributed profits under Section 26 of the Revenue Act of 1936, the taxpayer claimed a credit of $75,085.26 for contracts restricting dividend payments. The Commissioner disallowed the credit and the Board of Tax Appeals affirmed on review.

Summary of Argument.

The taxpayer has not discharged the burden resting upon it to prove that it could not legally have paid dividends in 1936, the taxable year, under the laws of Washington, the state of incorporation. The mere fact that taxpayer had an operating deficit at the close of 1935 does not compel the conclusion that it could not have declared dividends out of its net profits for 1936 so long as it had sufficient surplus, and the record does not disclose that it did not.

Assuming *arguendo* that taxpayer could not legally have paid dividends during 1936, still it is not entitled to the credit claimed by it under Section 26 (c) (1) of the Revenue Act of 1936 in the absence of a written contract executed by the corporation prior to May 1, 1936, which expressly deals with and prohibits payment of such dividends. No such contract is in evidence nor does the charter of the corporation, supplemented by the statutes of the State of Washington, where the company was incorporated, constitute such a contract within the meaning of the statute relied upon to support the credit.

There is no constitutional prohibition against denial of the claimed credit, for the law, as construed by the Commissioner and the Board, is a wholly reasonable attempt by Congress to check evasions of surtaxes on corporate earnings by subjecting them to surtax either in the hands of the stockholders or in the hands of the corporations themselves. Nor does the law, as so construed, constitute an unwarranted federal interference with the power of the states to control the distribution of corporate earnings, for Congress in raising revenue has incidental power to defeat obstructions to that incidence of taxes which it chooses to impose.

ARGUMENT.

I

The taxpayer has not proved that it could not legally have paid dividends during the taxable year 1936.

The taxpayer's case is bottomed upon the contention that under the laws of Washington, the state of incorporation, it could not have paid out as dividends any of the profits upon which the surtax here involved has been imposed. The Board of Tax Appeals, in sustaining the Commissioner, did not specifically answer this question but decided the case on the authority of its decision in *Crane Johnson Co.* v. *Commissioner*, 39 B. T. A. 1355, affirmed August 3, 1939 (C. C. A. 8th), not yet officially reported, but may be found in 1939 C. C. H., Vol. 4, ¶ 9652, involving a similar situation with respect to a North Dakota corporation.

Under the applicable Washington statute (Remington's Revised Statutes of Washington, Vol. 5, Title 25, Sec. 3803-24, see Appendix, *infra*), the taxpayer was prohibited from paying dividends in cash or property "except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock, after deducting from such aggregate of its assets the amount by which such aggregate was increased by unrealized apreciation in value or revaluation of fixed assets." Section 3803—25 (see Appendix, *infra*) imposes liabilities upon directors and stockholders declaring or receiving dividends paid in violation of law.

In the instant case, the record shows and the Board found that taxpayer's surplus by appraisal at the beginning and end of 1936, the taxable year, was $134,173.90; that its operating deficit as of December 31, 1935, was $76,983.26 and its net income for the year ended December 31, 1936, was $76,049.71; that taxpayer owed about $115,000 to a bank in 1934 which was reduced to $85,000 by July, 1936, at which time that amount was paid. Although the general manager of the taxpayer testified that the company was not in a position to pay

dividends, still such testimony is a mere conclusion which adds nothing to the facts in evidence.

It is submitted that those facts do not justify the conclusion that this taxpayer was prohibted by the Washington statute above referred to from paying out as dividends in 1936 its net profits of some $76,000. No certified financial statements are in evidence. Certainly the mere fact that taxpayer had an operating deficit at the beginning of the year would not prevent it from declaring dividends out of its profits during the taxable year so long as it had sufficient surplus and the record does not show that it did not. On the other hand, the record does show "surplus by appraisal" of some $134,000 and that would be more than sufficient to cover a dividend of $76,000 unless such surplus was created by "unrealized appreciation in value or revaluation of fixed assets" and the record does not show that it was.

It is therefore impossible to say on the record in this case that the taxpayer was not in a position to pay dividends during the taxable year 1936. Hence taxpayer has failed to sustain the burden of proof resting upon it in this proceeding. *New Colonial Co.* v. *Helvering,* 292 U. S. 435; *Welch* v. *Helvering,* 290 U. S. 111.

We have no quarrel with the Washington cases cited by the taxpayer on pages 11-12 of its brief on this appeal, although it may be noted in passing that none of them relates to the statute in question here which is part of the Uniform Business Corporation Act adopted in Washington effective January 1, 1934. Remington's Revised Statutes of Washington, Vol. 5, Sec. 3803-67. Moreover, it does not follow from cases like *Jorguson* v. *Apex Gold Mines Co.,* 74 Wash. 243, that the taxpayer could not have paid dividends in 1936, for there the court said (p. 244) that dividends can be paid only out of the profits or surplus earnings of the corporation and (p. 245) that there were no profits nor surplus out of which the dividend could be paid, while here, in the instant case, the taxpayer concededly made net profits of some $76,000 during the taxable year and had a "surplus by appraisal" of some $134,000. Indeed, in a New Jersey case *(Goodnow* v. *American Writing Paper Co.,* 73 N. J. Eq. 692) involving a statute similar to the Washington statute prior to the 1934 amendment, it was held

that a dividend may be declared out of profits even though the total assets of the company may not exceed its debts and the nominal share capital. See also *United Light & Power Co.* v. *Grand Rapids Trust Co.*, 85 F. (2d) 331, 336 (C. C. A. 6th), certiorari granted, 299 U. S. 534, dismissed per stipulation, 299 U. S. 618; Cook, Corporations, Eighth Ed., Vol. II, Sec. 546. pp. 1905-1908.

In the light of these considerations, it seems clear that the taxpayer has failed to prove that it was prohibited from declaring dividends from its 1936 profits either under the Uniform Business Corporation Act adopted in Washington in 1934 or under the cases cited by taxpayer which deal with the law prior to the 1934 amendment.

II.

Assuming *arguendo* that taxpayer could not legally have paid dividends in 1936, still it is not entitled to the claimed credit in the absence of a written contract expressly prohibiting payment of such dividends; and the corporate charter and State laws do not constitute such a contract within the meaning of Section 26 of the Revenue Act of 1936 upon which the taxpayer relies in support of its claim for credit.

The next point to be considered is whether the taxpayer is entitled to the claimed credit even if it had no legal right to distribute as dividends the net profits of 1936 which are here involved. The taxpayer urges (Br. 12-17) that its charter constitutes a "written contract executed by the corporation" within the meaning of Section 26 (c) (1) of the Revenue Act of 1936, which is the statutory provision relied upon by taxpayer in support of its claim for credit.

This question recently was passed upon by the Circuit Court of Appeals for the Eighth Circuit in *Crane Johnson Co.* v. *Commissioner, supra.* In deciding in favor of the Government, the court pointed out that for some purposes the charter of a corporation may be said to be a contract with the state (*Dartmouth College* v. *Woodward,* 4 Wheat. 517), and the laws, constitutional or statutory, of the state of incorporation may become part of the charter (see *Ainsworth* v. *Southwestern Drug Corp.*, 95 F. (2d) 172, 173 (C. C. A. 5th); *Jones* v. *Missouri-Edison Electric Co.*, 144 Fed. 765, 770 (C. C. A. 8th)).

The court then referred to the North Dakota statutes relating to payment of dividends which are similar to the Washington statute here involved and concluded that such statutes do not establish a contract executed by the corporation expressly dealing with payment of dividends within the meaning of Section 26 (c) (1) of the Revenue Act of 1936; and in that connection the court said that under the North Dakota statutes the liability in respect of improper dividends is purely one between the directors and the creditors so that "the corporation itself has made no written contract affecting its right to declare dividends."

The reasoning of the Eighth Circuit in the *Crane Johnson* case is fully applicable in the instant case for the corporate charter in the instant case (R. 58-66) contains no specific provisions as to payment of dividends and taxpayer has pointed out no provision of the applicable Washington statute (see Appendix, *infra)* imposing liability on the corporation itself as distinguished from liabilities of directors or stockholders in respect of dividends paid in violation of law.

It is submitted that taxpayer is in effect attempting to distort the meaning and scope of Section 26 (c) (1) so as to include therein a credit in respect of amounts paid in discharge of its indebtedness to the bank pursuant to an oral understanding, which amounts would be allowable if at all under Section 26 (c) (2), see Appendix, *infra,* but clearly are excluded therefrom by the requirement with respect to a written contract which concededly did not exist between the corporation and the bank. (R. 17-18, 31.) It is thought equally clear that Congress did not intend to include credits such as here claimed under the provisions of Section 26 (c) (1), and the Eighth Circuit so indicated in the *Crane Johnson* case, *supra,* saying with regard thereto:

> It is worthy of note that an analogous provision is found in Sec. 26 (c) (2) of the Revenue Act of 1936, which allows a credit of an amount equal to the portion of the earnings and profits of the taxable year which is required "by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the

taxable year for the discharge of a debt; to the extent that such amount has been paid or set aside." Clearly, this provision relates to a corporate undertaking to discharge a certain obligation out of earnings, and not to any statutory provisions. These similar provisions should be construed by the same rule.

Furthermore, if the meaning of Section 26 (c) (1) be considered doubtful, then reference should be made to the legislative history *(Taft* v. *Commissioner,* 304 U. S. 351, 355), which makes the Congressional purpose perfectly plain.

The legislative history of the undistributed profits tax imposed by the Revenue Act of 1936 supports the view that Congress did not intend to give special treatment to corporations which had deficits and were prohibited by state law from distributing dividends.[1] The Bill as introduced into the House contained three distinct provisions designed to relieve corporations which had a deficit or which for various reasons could not or should not pay dividends. Section 14 (a) provided that if the accumulated earnings and profits of the corporation as of the close of the taxable year (computed without diminution by reason of the distribution during the taxable year of earnings and profits, or by reason of the taxes imposed by Title I of the Act) were less than the adjusted net income, the tax should be computed in a different manner. This provision was intended to relieve corporations having a deficit. Section 15 was designed for the relief of corporations having outstanding contracts with respect to dividends, and Section 16 was intended for the relief of corporations having an outstanding indebtedness. (H. R. 12395, 74th Cong., 2d Sess., Secs. 14, 15 and 16).

In explanation of those provisions the Committee on Ways and Means stated (H. Rep. No. 2475, 74th Cong., 2d Sess., pp. 8-9):

EXCEPTIONS FROM GENERAL PLAN.

It has been recognized that in certain cases corporations cannot pay out dividend or that sound policy demands the nonpayment of dividends. Therefore, in certain

[1] See also the analysis of the legislative history of Section 26 (c) (1) contained in *Crane-Johnson Co.* v. *Commissioner, supra,* 38 B. T. A. 1355, 1364-1368.

cases, a flat rate of tax is imposed on corporate incomes, or parts thereof, in lieu of the undistributed profits tax proposed in the general case.

Deficits.—For example, section 14 of the bill provides that corporations with a deficit shall pay a tax of 22½ percent on the amount of earnings necessary to make up this deficit and only come under the new plan in respect to earnings in excess of this deficit, and in excess of the tax paid at the 22½-percent rate. This rule is more accurately stated in the section.

Contracts not to pay dividends.—In section 15, a similar treatment is accorded in respect to that part of corporate net income that cannot be paid out in dividends without violating a written contract in existence prior to March 3, 1936.

Debts.—In section 16 similar relief is given in case of certain debts which are in excess of the accumulated earnings and profits.

It is also provided that sections 14, 15 and 16 noted above shall not operate to increase the tax which would be payable without the application of such sections. A corporation, however, cannot use more than one of the relief provisions just cited but must use the one which will result in the smallest tax.

The Committee on Finance of the Senate substituted for the graduated undistributed profits tax a flat surtax of 7% on undistributed profits. It also struck out Sections 14, 15 and 16 of the House Bill, but in Section 26 (c) (1) retained the principle of Section 15 of that Bill affording relief to corporations under contract not to pay dividends.

In explanation of these changes the Committee on Finance said (S. Rep. No. 2156, 74th Cong., 2d Sess., pp. 12-13, 15):

SURTAX ON UNDISTRIBUTED PROFITS.

Section 14 of the committee bill imposes a surtax of 7 percent upon the amount of the undistributed net income of corporations. This, together with the normal tax on corporations, is a complete substitution for the undistributed-profits tax provision of the House Bill. Instead of having a graduated undistributed-profits tax like the

House bill with rates ranging as high as 42.5 percent, your committee has adopted a flat rate of 7 percent. By this moderate rate your committee has eliminated most of the complicated relief provisions in the House bill relating to debt and deficit corporations. However, the principle of the House bill affording relief to corporations which are unable to pay dividends because of express prohibitions in contracts entered into prior to March 3, 1936, have been retained for the purpose of the 7-percent undistributed-profits tax.

The term "undistributed net income" is defined in the bill to mean the adjusted net income minus (1) dividends paid during the taxable year, and (2) the amount of the adjusted net income which the corporation is prohibited by contract as defined in section 26 (c) from paying as dividends during the taxable year. The adjusted net income consists of the net income of the corporation reduced by the following:

(1) The normal tax on corporations imposed by section 13;

(2) Interest on United States and Government obligations;

(3) The amount allowed as a credit to a bank holding company affiliate under section 26 (d).

* * * * * * * *

SECTION 26. CREDITS OF CORPORATIONS.

This section sets forth certain credits allowed to corporations in computing the various taxes imposed under title 1. In general, they are as follows:

* * * * * * * *

(3) Contracts not to pay dividends: This credit is in principle similar to a relief provision allowed in the House bill for the purpose of the undistributed-profits tax imposed by that bill. It is allowed as a credit in computing undistributed net income for the purpose of the surtax on undistributed profits imposed by section 14 and in computing retained net income for the purpose of the tax imposed by section 102.

* * * * * * * *

An amendment to Section 26 (c) on the floor of the Senate restored the credit allowed to corporations under contract

to pay indebtedness which had been contained in Section 15 of the House bill. See Section 26 (c) (2) of the Revenue Act of 1936 (Appendix, *infra*, p. 66); Cong. Record, Vol. 80, Part 8, 74th Cong., 2d Sess., pp. 8790-8791, 9071. A graduated rate was also substituted for the flat surtax rate which the Senate Finance Committee had adopted. But no provision for the relief of deficit corporations analogous to Section 14 of the House Bill was restored to the Bill. See H. Conference Rep. No. 3068, 74th Cong., 2d Sess., pp. 2-4. See also Cong. Record, *supra*, p. 9071.

By a change in the definition of a dividend in Section 115 (a) of the Revenue Act of 1934, the Bill as passed permitted dividends paid credit to deficit corporations which actually distributed current earnings (see section 27 of the Revenue Act of 1936, U. S. C. Supp. IV, Title 26, Sec. 27); but none was allowed to deficit corporations which did not distribute.

Thus the failure of Congress to provide specifically for the allowance of a credit to corporations which had a deficit and were prevented by state law from paying out dividends appears to have been deliberate. Sectoin 14 of the House Bill would have given them relief but the Bill as finally enacted did not do so. It appears, moreover, that the purpose of the Senate in making the change was to eliminate the necessity of determining when there was a deficit, for, in explaining Section 115 (a) the Committee on Finance said (S. Rep. No. 2156, *supra*, p. 18):

> SECTION 115 (A). DIVIDENDS OUT OF CURRENT EARNINGS
>
> In order to enable corporations without regard to deficits existing at the beginning of the taxable year to obtain the benefit of the dividends paid credit for the purposes of the undistributed profits surtax, section 115 (a) changes the definition of a dividend so as to include distributions out of the earnings or profits of the current taxable year. The amendment simplifies the determination by providing that distributions during the year, not exceeding in amount the current earnings, are dividends constituting taxable income to the shareholder and a dividend paid credit to the corporation. As respects such dividends the complicated determination of accumulated earnings or profits is rendered unnecesary.

Attention is also called to the fact that Senator Walsh, a member of the Senate Finance Committee stated on the floor of the Senate that the Bill did not afford relief to corporations which were prevented by state law from declaring dividends except from earnings. His statement was as follows (Cong. Record, Vol. 80, Part 8, *supra*, p. 9058):

> Again, the laws of 36 States prohibit corporations chartered by them from making a dividend distribution if their capital is impaired. Under the proposed undistributed-profits tax, corporations affected by these provisions would be heavily penalized by the Federal tax for keeping within the law. The House bill taxes these corporations a flat rate on their net income of 22½ percent, regardless of their dividend policy.

It should also be noted that when the Bill which subsequently became the Revenue Act of 1938 was reported to the House of Representatives, the Committee on Ways and Means stated that one of the principal objections to the surtax on undistributed profits imposed by the Revenue Act of 1936 was that it was unfair to corporations with impaired capital which under state law cannot legally declare dividends. It was for that and other reasons that Congress substantially modified the undistributed profits tax imposed by the Revenue Act of 1938, c. 289, 52 Stat. 447. (H. Rep. No. 1860, 75th Cong., 3d Sess., pp. 3-4.) No provision analogous to Section 26 (c) (2) appears in that Act but certain relief for deficit corporations was afforded by the consent dividends credit provided for in Section 28 of that Act. With reference to that section the Committee made the following statement (H. Rep. No. 1860, *supra*, p. 24):

> SECTION 28. CONSENT DIVIDENDS CREDIT.
>
> One of the principal objections which has been urged to any form of corporation tax measured by undistributed profits has always been that many corporations, for a variety of reasons, find it difficult, if not impossible, in

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[illegible] the hearings before both Committees of Congress, attention was repeatedly called to the situation of companies located in such states. Hearings before the Committee on Ways and Means, House of Representatives, 74th Cong., 2d Sess., pp. 101-102, 836-837, 842, 846-847; Hearings before the Committee on Finance, United States Senate, 74th Cong., 2d Sess., on H. R. 12395, pp. 234, 269, 282, 417.

certain situations to declare dividends in cash or scrip or to distribute taxable stock dividends. Section 28 of the bill is intended to provide a method whereby such a corporation, with the cooperation of its shareholders, may obtain the tax benefits incident to actual distribution without violation of any contractual commitment or any rule of law which might prevent it, in whole or in part, from distributing its earnings and without depriving the Government of the revenue which would flow from the receipt of dividends by the shareholders.

Thus the legislative history of the Act supports the view that the failure of Congress to provide specifically for the relief of deficit corporations was deliberate and that it did not consider that the provisions granting relief to corporations having a written contract executed by them not to pay dividends afforded relief to corporations prohibited by state law from making distributions except from earnings.

The Bureau of Internal Revenue has consistently held that the charter of a corporation does not constitute a written contract executed by the corporation within the meaning of Section 26 (c) of the Revenue Act of 1936. Article 26-2 of Regulations 94, *infra,* promulgated under the statute here involved so provides. See, also, T. D. 4674, XV-2 Cum. Bull. 53, 58 (1936). In I. T. 3016, XV-2 Cum. Bull. 73 (1936), it was specifically held that a corporation which was restricted by state law from paying dividends while its capital remained impaired was not entitled to special treatment under Section 26 (c) (1).

Clearly Congress did not intend that the right to the credit should depend upon or vary in accordance with state laws. The situation here is not unlike that in *Lyeth* v. *Hoey,* 305 U. S. 188, where the court said (p. 194):

> In dealing with the meaning and application of an act of Congress enacted in the exercise of its plenary power under the Constitution to tax income and to grant exemptions from that tax, it is the will of Congress which controls, and the expression of its will, in the absence of language evidencing a different purpose, should be interpreted "so as to give a uniform application to a nation-

wide scheme of taxation." *Burnet* v. *Harmel*, 287 U. S. 103, 110. Congress establishes its own criteria and the state law may control only when the federal taxing act by express language or necessary implication makes its operation dependent upon state law. *Burnet* v. *Harmel*, *supra*. See *Burk-Waggoner Oil Assn.* v. *Hopkins*, 269 U. S. 110, 111, 114; *Weiss* v. *Wiener*, 279 U. S. 333, 337; *Morrissey* v. *Commissioner*, 296 U. S. 344, 356. Compare *Crooks* v. *Harrelson*, 282 U. S. 55, 59; *Poe* v. *Seaborn*, 282 U. S. 101, 109, 110; *Blair* v. *Commissioner*, 300 U. S. 5, 9, 10. There is no such expression or necessary implication in this instance. * * *

There is no expression or implication in Section 26 (c) (1) which would require allowance of the credit in one state and disallowance in another, depending upon their peculiar laws respecting dividend payments. On the other hand, Congress clearly had in mind and intended to establish a uniform rule which would operate without regard to state laws.

Taxpayer urges (Br. 17) that in case of doubt, the statute must be construed in favor of the taxpayer; but not only does the meaning of Section 26 (c) (1) appear plain when applied to the facts in the instant case, but even were it otherwise, still the rule as to resolving doubts against the Government does not apply where exemptions, special privileges or deductions are claimed (*Helvering* v. *Inter-Mountain Life Insurance Co.*, 294 U. S. 686, 689) and in such cases the taxpayer must bring himself squarely within the scope of the statute relied upon to support the deduction.

In the light of these considerations, it seems clear that the claimed credit was properly denied in the instant case.

III.

There is no constitutional prohibition against denial of the claimed credit.

Taxpayer takes the position (Br. 18-23) that the provisions of the law imposing a surtax on undistributed profits are unconstitutional unless construed so as to allow credits such as claimed in this case; also (Br. 23-25) that Section 26 of the Revenue Act of 1936 is arbitrary and discriminatory,

in that it permits credit as to a written contract but denies credit as to an oral contract of the same terms.

Taxpayer also made these contentions before the Board of Tax Appeals which held them without merit upon the authority of the Board's decision in *Crane Johnson Co.* v. *Commissioner, supra,* which, as above pointed out, has now been affirmed by the Circuit Court of Appeals for the Eighth Circuit. In that case, the taxpayer urged on appeal that if construed to tax a corporation because it failed to do an unlawful and criminal act, the statute violates the Fifth Amendment. But the court said that since no North Dakota statute made it a crime to declare a dividend out of capital, the taxpayer was urging the court to decide a question of constitutional law based upon a hypothetical set of facts, which is not permissible, citing *Tennessee Pub. Co.* v. *Amer. Bank,* 299 U. S. 18; *Cincinnati* v. *Vester,* 281 U. S. 439; *Anniston Mfg. Co.* v. *Davis,* 301 U. S. 337.

The situation in the instant case is substantially similar to the one in the *Crane Johnson Co.* case, for here there appears to be no Washington statute making it a crime to declare dividends out of capital, and moreover, as shown under Point I of this brief, the record herein does not disclose that the net profits of some $76,000 which have been subjected to surtax could not legally have been declared out as dividends.

Moreover, as also pointed out by the court in the *Crane Johnson* case, *supra,* "Congress has the power to levy a tax on corporate net income even though there be an impairment of capital." *Willcuts* v. *Milton Dairy Co.,* 275 U. S. 215, 220.

Taxpayer says (Br. 22) that the act here under discussion constitutes an illegal federal interference with state power to control the distribution of corporate earnings; but in so contending, taxpayer not only ignores the *Milton Dairy Co.* case, *supra,* but also the more recent decision of the Supreme Court in *Helvering* v. *Nat. Grocery Co.,* 304 U. S. 282, where the court sustained the constitutionality of Section 104 of the Revenue Act of 1928 as applied to corporations availed of for the purpose of preventing the imposition of surtaxes upon its shareholders. In that connection the court said (pp. 286-287):

It is said that the statute violates the Tenth Amendment because it interferes with the power to declare or to withhold dividends—a power which the State conferred upon the corporation. The statute in no way limits the powers of the corporation. It merely lays the tax upon corporations which use their powers to prevent imposition upon their stockholders of the federal surtaxes. "Congress in raising revenue has incidental power to defeat obstructions to that incidence of taxes which it chooses to impose." *United Business Corp.* v. *Commissioner,* 62 F. (2d) 754, 756

And in *United Business Corp.* v. *Commissioner,* 62 F. (2d) 754 (C. C. A. 2d), cited by the Supreme Court in the *Nat. Grocery Co.* case, *supra,* the court said (p. 756):

> * * * companies may accumulate what profits they please so long as they do not do so to defeat the fiscal policies of the United States. Their business, whose regulation is wholly for the states, does not include the manipulation of dividends to avoid taxes; by definition that has nothing to do with the normal management of their affairs. Congress in raising revenue has incidental power to defeat obstructions to that incidence of taxes which it chooses to impose.

See also *Almours Securities* v. *Commissioner,* 91 F. (2d) 427, 429 (C. C. A. 5th), certiorari denied, 302 U. S. 765, rehearing denied, 303 U. S. 666.

In the light of those decisions, there seems no merit to the contention that Congress, by levying a surtax at graduated rates on undistributed net income, has exceeded its constitutional powers and violated the Tenth Amendment merely because credits are not allowed in respect of all restrictions existing under state law. The taxpayer has cited no case and we know of none where it has been held that deductions or credits must be allowed in cases such as here presented merely because disallowance might in some measure interfere in the affairs of a corporation regulated by state law. In this connection, it seems not inappropriate to note that the Supreme Court in cases decided during its last term has reconsidered and narrowed the doctrine of implied immunities of either gov-

ernment, state or national, and its instrumentalities from taxation by the other. *Graves* v. *N. Y., ex rel. O'Keefe,* 306 U. S. 466; *State Tax Comm'n* v. *Van Cott,* 306 U. S. 511.

Taxpayer also says (Br. 22) that "the tax is a penalty tax" and hence unconstitutional. But even assuming *arguendo* that the tax may in some measure constitute a penalty in that it is imposed in respect of profits which are not distributed, still it is settled that this in itself would not make the law unconstitutional. *Helvering* v. *Nat. Grocery Co., supra,* where the court said (pp. 288-289) that the penal nature of the imposition there in question did not prevent its being valid, as the tax was otherwise permissible under the Constitution. Cf. also *Helvering* v. *Mitchell,* 303 U. S. 391; see *United States* v. *Butler,* 297 U. S. 1, 61. In any event, it is thought that the imposition here involved is a true tax intended to raise revenue for governmental purposes and not an attempt to regulate the activities of state corporations under the guise of a tax. See report of Committee on Ways and Means, H. Rep. No. 2475, 74th Cong., 2d Sess., pp. 1-3, quoting from the message of the President dated March 3, 1936, from which it clearly appears that the purpose of the law was to check evasions of surtaxes on corporate earnings by allowing them to remain undistributed.

It is settled that Congress may pass measures reasonably calculated to prevent avoidance of taxes (cf. *Helvering* v. *City Bank Co.,* 296 U. S. 85; *Reinecke* v. *Smith,* 289 U. S. 172) and it is submitted that the tax herein involved, far from being an evidence of despotism, is a wholly reasonable attempt to prevent avoidance of tax.

Moreover, there is no merit to the contention of taxpayer (Br. 25) that the act is unconstitutional to the extent that it allows credits in respect of written contracts and denies them as to oral contracts with the same terms. Deductions or credits of this type are a matter of legislative grace within the sound discretion of Congress *(New Colonial Co.* v. *Helvering, supra),* and the taxpayer is in no position to complain if this grace was not extended to cover it. As pointed out in the opinion of the Board of Tax Appeals in the *Crane Johnson Co.* case, *supra,* p. 1360, the due process limitations on the taxing power are that the means be appropriate to the end *(Helvering* v.

City Bank Co., supra) and that the end be taxation rather than confiscation. *Brushaber* v. *Union Pac. R. R.*, 240 U. S. 1. Since, as above pointed out, the objective of the instant statute is to check evasions, it seems clear that the taxpayer may not complain because in certain instances corporations unable for other reasons to distribute their income are expressly exempted or are allowed deductions or credits having a similar effect, so long as the law, read as a whole in the light of its purpose, is not unduly harsh nor unreasonable. Cf. *Burnet* v. *Wells*, 289 U. S. 670; *LaBelle Iron Works* v. *United States*, 256 U. S. 377; *Graham & Foster* v. *Goodcell*, 282 U. S. 409.

As above pointed out, we question whether any failure to provide for a deduction or credit could be said to violate the Constitution even if considered to amount to an arbitrary classification because another deduction was granted which could also have been omitted, since all deductions are discretionary. But even if we are wrong in that view, we submit that there was a rational basis for the distinctions between written and oral contracts and between ordinary written contracts and particular state statutes relating to payment of dividends. It is a comparatively easy matter for the Bureau of Internal Revenue to ascertain whether an ordinary written contract prohibits payment of dividends. But it would be an almost insuperable burden for the Bureau to determine the validity and scope of oral contracts of that nature; and it would be almost as difficult for the Bureau to examine corporate charters in the light of the varying and complex state laws appertaining thereto as well as the financial histories of the corporations, in order to determine the right of a given taxpayer to credit. The tax laws are based largely upon practical considerations and may not always embody perfect economic theory. *Weiss* v. *Wiener*, 279 U. S. 333, 335; *Fraser* v. *Commissioner*, 25 F. (2d) 653, 654 (C. C. A. 2d).

See also *Crane Johnson Co.* v. *Commissioner, supra*, 38 B. T. A. 1355, 1360-1361, for additional reasons why the law, as construed by the Commissioner, is considered reasonable under the circumstances.

In conclusion, we submit that the law in question is a wholly reasonable effort to check evasions of surtaxes and viewed in that light there is no basis for the taxpayer's contention

that it is unreasonable and unjustly discriminatory in its application to the taxpayer and other corporations similarly situated. Cf. *Crane Johnson Co.* v. *Commissioner, supra; Co-operative Publishing Co.* v. *Commissioner,* 40 B. T. A. No. 70.

Conclusion.

The decision of the Board of Tax Appeals is correct and should be affirmed.

Respectfully submitted,

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September, 1939.

Appendix.

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) Definitions.—As used in this title—

* * * * * * * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

* * * * * * * *

(U. S. C. Supp. IV, Title 26, Sec. 13a.)

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall

be allowed to the extent provided in the various sections imposing tax—

* * * * * * * *

(c) Contracts Restricting Payment of Dividends.

(1) *Prohibition on payment of dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) *Disposition of profits of taxable year.* — An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "Debt" does not include a debt incurred after April 30, 1936.

(3) *Double credit not allowed.*—If both paragraph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

* * * * * * * *

(U. S. C. Supp. IV, Title 26, Sec. 26.)

Remington's Revised Statutes of Washington, Vol. 5, Title 25, c. 1-A:

§3803-24. *Capital carried as liability—Computation—Dividends how paid.*

1. Every corporation shall carry upon its books as a liability the amount of its capital stock as defined in section 3803-1, subdivision 10.

2. Amounts of surplus arising from an unrealized appreciation or revaluation of fixed assets shall be shown on the books of the corporation as a separate item apart from surplus profits or paid-in surplus.

3. In computing the aggregate of the assets of the corporation, the board of directors shall determine and make proper allowance for depreciation and depletion sustained, and losses of every character. Deferred assets and prepaid expenses shall be written off at least annually in proportion to their use as may be determined by the board of directors.

4. No corporation shall pay dividends,

a. in cash or property, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock, after deducting from such aggregate of its assets the amount by which such aggregate was increased by unrealized appreciation in value or revaluation of fixed assets;

b. in shares of the corporation, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock.

5. Cash dividends shall not be paid out of surplus due to or arising from,

a. any profit on treasury shares before resale; or

b. any unrealized profits due to increase in valuation of inventories before sale; or

c. the unaccrued portion of unrealized profits on notes, bonds, or obligations for the payment of money purchased or acquired at a discount unless such notes, bonds,

or obligations are readily marketable, in which case they may be taken at their actual market value; or

d. the unaccrued or unearned portion of any unrealized profit in any form whatever, wherther in form of notes, bonds, obligations for the payment of money, installment sales, credits or otherwise.

6. Subject to the limitations contained in this section, a dividend may be declared in shares of the corporation whenever the board of directors so determine: *Provided,* That

a. if the dividend is to be paid in shares having a par value, the aggregate par value of such shares shall not exceed the amount of that portion of the corporation's surplus which is tranferred to capital as payment for such shares;

b. if the dividend is paid in shares having no par value, the number of such shares may be fixed by the board of directors;

c. no dividend payable in shares of any class shall be paid to shareholders of any other class unless the articles so provide or such payment is authorized by the vote of the holders of a majority of the shares of the class in which the payment is to be made.

7. A corporation which owns wasting assets intended for sale in the ordinary course of business, such as mines, or oil or gas wells, or timber, or a corporation which owns property having a limited life, such as a lease for a term of years, or patents, need not deduct the depletion of such assets by sale or lapse of time in the computation of the fund available for dividends, and such a corporation may pay dividends from the net profits arising from its business without deduction of such depletion, subject, however, to the rights of the shareholders of different classes. [L. '33, p. 785, § 24]

§ 3803-25. *Unlawful dividends.*—If any dividend be paid in violation of section 3803-24, or if any other unlawful distribution, payment or return of assets be made to shareholders.

1. The directors who knowingly, or without making reasonable inquiry, voted in favor thereof shall be jointly

and severally liable to the corporation in an amount equal to the amount of the dividend so paid and the distribution, payment or return of assets so made;

2. Every shareholder who received any such dividend or any such distribution, payment or return of assets shall in the following instances be individually liable to the corporation in an amount equal to the amount so received by him:

a. when no director is liable to the corporation as provided in subdivision 1 of this section, or

b. to the extent that the corporation is unable to obtain satisfaction after judgments recovered against directors upon the liability imposed by subdivision 1 of this section.

3. No action shall be brought against a director, under subdivision 1, or against a shareholder under subdivision 2

a. unless brought within two years from the date on which such payment, distribution or return was made; and no action shall be brought against a shareholder, under subdivision 2

b. unless brought within two years from the date of final judgment against the directors. [L. '33, p. 787, § 25.]

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 14-1. *Surtax on undistributed profits of corporations.*—In general, the Act imposes a surtax on the net income of corporations in an amount measured by the undistributed net income. The rates of surtax are graduated in brackets, the lowest rate being 7 percent of that portion of the undistributed net income not in excess of 10 percent of the adjusted net income and the highest rate being 27 percent of that portion of the undistributed net income which is in excess of 60 percent of the adjusted net income.

* * * * * * * *

The undistributed net income is defined in section 14 (a) (2) as the adjusted net income minus the sum of (*a*) the dividends paid credit provided in section 27 (see ar-

ticles 27 (a)-1 to 27 (h)-1, inclusive), and (*b*) the credit provided in section 26 (c), relating to contracts restricting the payment of dividends (see article 26-2).

* * * * * * * *

ART. 26-2. *Credit in connection with contracts restricting payment of dividends.*—(*a*) The credit provided in section 26 (c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. The charter of the corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c). The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

If a corporation is restricted with respect to the payment of dividends by two or more contract provisions coming within section 26 (c) (1), only the largest of the credits computed with respect to each of such provisions, and not their sum, shall be allowable under section 26 (c) (1) and, for such purpose, if two or more credits are equal in amount, only one shall be taken into account. However, section 26 (c) (3) provides that if both section 26 (c) (1) and section 26 (c) (2) apply, only the one of such paragraphs which allows the greater credit shall be applied, and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

(*b*) *Prohibition on payment of dividends.*— The credit provided in section 26 (c) (1) is allowable only with respect to a written contract executed by the corporation prior to May 1, 1936, which expressly deals with the payment of dividends and operates as a legal restric-

tion upon the corporation as to the amounts which it can distribute within the taxable year as dividends. If an amount can be distributed within the taxable year as a dividend—

(1) in one form (as, for example, in stock or bonds of the corporation) without violating the provisions of a contract, but cannot be distributed within the taxable year as a dividend in another form (as, for example, in cash) without violating such provisions, or

(2) at one time (as, for example, during the last half of the taxable year) without violating the provisions of a contract, but cannot be distributed as a dividend at another time within the taxable year (as, for example, during the first half of the taxable year) without violating such provision—there the amount is one which, under section 26 (c) (1), can be distributed within the taxable year as a dividend without violating such provisions.

The credit provided in section 26 (c) (1) is equal to the excess of the adjusted net income, as defined in section 14 (a), over the aggregate of the amounts which can be distributed within the taxable year without violating the provisions of such contract. The requirement that the provisions of the contract expressly deal with the payment of dividends is not met in case (1) a corporation is merely required to set aside periodically a sum to retire its bonds, or (2) the contract merely provides that while its bonds are outstanding the current assets shall not be reduced below a specified amount.

* * * * * * * * *

(c) *Disposition of profits of taxable year.*—Under the provisions of section 26 (c) (2), a corporation is allowed a credit in an amount equal to that portion of the earnings and profits of the taxable year which, by the terms of a written contract executed by the corporation prior to May 1, 1936, and expressly dealing with the disposition of the earnings and profits of the taxable year, it is required within the taxable year to pay in, or irrevocably to set aside for, the discharge of a debt incurred on or before April 30, 1936. The credit is limited to that amount which is actually so paid or irrevocably

set aside during the taxable year pursuant to the requirements of such a contract.

Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable year shall be recognized as a basis for the credit provided in section 26 (c) (2). A corporation having outstanding bonds is not entitled to a credit under a provision merely requiring it, for example, (1) to retire annually a certain percentage or amount of such bonds, (2) to maintain a sinking fund sufficient to retire all or a certain percentage of such bonds, by maturity, (3) to pay into a sinking fund for the retirement of such bonds a specified amount per thousand feet of timber cut or per ton of coal mined, or (4) to pay into a sinking fund for the retirement of such bonds an amount equal to a certain percentage of gross sales or gross income. Such provisions do not expressly deal with the disposition of earnings and profits of the taxable year. A contractual provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of "net income," "net earnings," or "net profits."

The term "debt" as used in section 26 (c) (2) does not include an obligation of the corporation to a shareholder, as such, as distinguished from a creditor. Accordingly, amounts paid into, or set aside for, a sinking fund by a corporation for the retirement of preferred stock, pursuant to the terms of an agreement underlying the preferred stock issue, shall not be considered as set aside for discharge of a debt. An indebtedness evidenced by bonds or other similar obligations issued by a corporation is incurred as of the date such obligations are issued, and the amount of such indebtedness is the amount represented by the face value of the obligations. For the purpose of this article a bond or other similar obligation is not issued until it is executed and delivered to a person who holds it as a debt of the corporation. Bonds issued after April 30, 1936, in exchange in refunding a preexisting issue represent debts incurred after April 30, 1936, within the meaning of section 26 (c) (2).

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

No. 9207

NORTHWEST STEEL ROLLING MILLS, INC., *Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

REPLY BRIEF OF PETITIONER.

REPLY BRIEF OF PETITIONER.

Upon Petition to Review a Decision of the United States Board of Tax Appeals.

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REPLY BRIEF OF PETITIONER.

Upon Petition to Review a Decision of the United States Board of Tax Appeals.

It is conceded, as stated in respondent's brief, that this court has jurisdiction pursuant to §§1141-1142 of the Internal Revenue Code. We shall reply to respondent's arguments in the order in which respondent has presented them.

I.

Could Dividends Have Been Paid Legally During the Taxable Year 1936?

There is no dispute in the evidence that from January 2, 1934, when Harry Goetz became manager of petitioner (R. 49), the company had *never* been in a position to pay a dividend (R. 50). Nor is there any dispute that a deficit had accumulated from January 2, 1934 (R. 50). This evidence was admitted without objection. Respondent now argues, for the first time, that the testimony of Harry Goetz is a "conclusion."

If we assume that it was a "conclusion," nevertheless,

having been admitted without objection, and being undisputed, its constitutes proof of the fact.

"In approaching the questions presented for our decision, we have in mind the elementary rule that issuable facts need not be shown by direct evidence, but may be arrived at by fair inference. We have in mind also the rule that parties have a right to try their case on evidence which is not of the quality and character required by the law, and where such evidence is admitted without objection, it is the right and duty of the court to give it the same consideration as if it were legal evidence." *Schanbacher, et al.*, v. *Lucido Bros.*, 93 S. W. (2d) (Mo.) 1076, 1081.

"Agency of this case is a question of law to be determined by the court upon the primary facts, and such facts only should have been elicited from the witness upon this point, and the answer of the witness states a legal conclusion and was incompetent. *Ford Motor Co.* v. *Levesay*, 61 Okl. 231, 161 Pac. 901. This evidence was admitted however without objection and stands without any effort of the plaintiff to strike it from the records. When incompetent evidence is thus admitted it must be given its natural effect. This evidence therefore is sufficient to make a prima facie proof of agency * * *." *Stanley* v. *Wilkinson*, 229 Pac. (Okla.) 574, 576.

The following cases also support the proposition that even assuming a witness testifies to a conclusion, if such testimony is admitted without objection, it is of probative value.

Spicer, et al., v. *Henderson*, 43 S. W. (Texas) 27;
Sugerman, et al., v. *Stelling, et al.*, 135 N. Y. Supp. 595;
Ridenhour v. *Okla. Contracting Co.*, 45 S. W. (2d-Mo.) 108, 112;
Maine v. *May Stern Furniture Co.*, 21 S. W. (2d-Mo.) 211, 213;
Wood v. *Consolidated School Dist. No.* 13, 7 S. W. (2d-Mo.) 1018, 1021.

"Parties have a right to try their case on evidence which is not of the quality or character required by law,

and where such evidence is admitted without objection, it is the right and duty of the court or jury to give it the same consideration as if it were legal evidence." 23 C. J. 39, §1783, "Evidence."

Consequently, assuming which we do not concede, that the testimony of Mr. Goetz is only a conclusion, still it went in without objection and no attack was made upon it in the record. It was uncontroverted.

The Board treated the question of the Charter and its effect as one of law only (R. 17). Had the Board refused to accept the testimony referred to, and which was uncontroverted, such refusal would have been error.

> "Since no evidence whatever was submitted for respondent, it was error wholly to ignore this testimony." *Belridge Oil Co.* v. *Commr.*, (C. C. A.-9) 85 Fed. (2d) 762, 768.

The question for decision is whether the charter and laws constitute a written contract within the statute allowing a credit, there being no controverting evidence that a dividend could not have been paid. In the light of the foregoing, the Board was not called upon to make a finding on matters of fact not in dispute. If such a finding had been necessary, the proper course would be to remand for that purpose.

> *Eaton* v. *Commr.*, 81 Fed. (2d) 332 (C. C. A.-9);
> *Anderson* v. *Commr.*, 78 Fed. (2d) 636, 638 (C. C. A.-9);
> *Belridge Oil Co.* v. *Commr.*, 85 Fed. (2d) 762 (C. C. A. 9).

Respondent refers to surplus by *appraisal.* The Corporation Act of the State of Washington specifically provides that the Board of Directors

> "Shall determine and make proper allowance for depreciation and depletions sustained and losses of every character. Deferred assets and prepaid expenses shall be

written off, as least annually in proportion to their use as may be determined by the Board of Directors."

Uniform Business Corporation Act, Laws of 1933, p. 785, §24, State of Washington;
Rem. Rev. Stat. 3803-24 (3).

Surplus by appraisal does not indicate a real surplus for dividend purposes. Furthermore, under the decisions in the State of Washington, which decisions constitute corporate law which is part of the contract between the corporation, the state and the stockholders, the corporation could only pay dividends out of profits and it is stipulated that there was an operating deficit at the end of 1935 of $76,983.26 (R. 71). The income for 1936 did not equal the amount of said deficit (R. 71).

Respondent cites *Goodnow* v. *American Writing Paper Co.*, 73 N. J. Eq. 692, 69 Atl. 1014, and contends that a dividend may be declared out of profits even though the total assets of the company may not exceed its debts and the nominal share capital. However, under the New Jersey Act, considered in that case, it was provided that the directors of a corporation shall not make dividends, except from its surplus, *or from net profits* arising from the business of such corporation. The court stated:

> "Although the change in language indicates that the Legislature made a distinction between surplus and net profits, it does not necessarily follow that net profits mean the difference between gross earnings and what may be called operating expenses. Such profits may be called annual profits, *and it may be that by net profits the Legislature meant the net profits upon the whole of the company's business from its organization.*"

Respondent cites *New Colonial Ice Co.* v. *Helvering*, 292 U. S. 435, wherein it is said that a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms, and to *Welch* v. *Helvering*, 290 U. S. 111, wherein it is said that the Commissioner's ruling has the presumption of correctness and the petitioner has the burden of proving it to be wrong. There is another familiar rule,

however, stated in *Belridge Oil Co.* v. *Commr.*, (C. C. A. 9) 85 F. (2d) 762, as follows:

> "Where it appears * * * that the methods pursued were erroneous, the presumption that the determination of the Commissioner was prima facie correct no longer avails." *pp. 768, 769.*

And further, it is said in the same case:

> "The presumption that the determination of the Commissioner was prima facie correct no longer avails, where it appears, as in this record, it does appear, that the evidence overcomes such presumption." *p. 769.*

In the instant record, the evidence is undisputed that a dividend could not have been paid. If the charter and state laws constitute a contract within the meaning of §26 C, then obviously the method employed by the Commissioner is erroneous and any presumption of correctness would be overcome.

II.

Charter Is a Written Contract Within the Meaning of Section 26, C, Revenue Act of 1936.

Respondent relies upon *Crane Johnson Co.* v. *Commr.*, 105 F. (2d) 740 (Adv. Sh. No. 3) (C. C. A. 8). A petition for rehearing has been filed in that case. The decision is based upon the North Dakota statute which provides that:

> "The *directors* of corporations must not make dividends except from the surplus profits arising from the business thereof; nor must they divide, withdraw, or pay to the stockholders, or any of them, any part of the capital stock. * * *" §4543, North Dakota Compiled Laws of 1913.

Section 4544 imposes liability upon the directors for improper dividends in event of dissolution of the corporation. The court stated:

> "For some purposes, the charter of a corporation may be said to be a contract with the state, and the laws, constitutional or statutory, of the state where the corporation is organized *become a part of its articles of incorporation,*

so that the charter of a corporation organized under general law consists of its articles of incorporation *and the laws applicable thereto.* Here the articles of incorporation and such certificate as may have issued on the organization of the corporation contain no provision restricting dividend payments. It is necessary, therefore, to look to the statutes of North Dakota for the restriction, and to determine whether the state law of North Dakota is a written contract *executed by the corporation.*" (p. 743.)

The court then observes that §4543 contains a prohibition against improper declaration of dividend *by directors,* and that §4544 penalizes the directors under certain conditions.

"The obligation is that of the directors, and in the event of the improper exercise of their power to declare dividends, they, *as distinguished from the corporation,* may be held liable for the consequences of a violation of the statute. Under the North Dakota statutes the liability is statutory *and is purely one between the directors and the creditors. The corporation itself has made no written contract affecting its right to declare dividends.*" (p. 743.) (Italics ours.)

Basing its opinion upon the North Dakota statute, the court proceeds upon the premise that since the statute only relates to rights between the directors and the creditors, it does not constitute a prohibition against the corporation itself.

The statute in the State of Washington, however, is a direct prohibition *against the corporation.* It states:

"*No corporation* shall pay dividends, * * *" Rem. Rev. Stat. 3803-24 (4).

Furthermore, the section captioned "Unlawful Dividends" (Rem. Rev. Stat. 3803-25) not only provides for remedies against directors who knowingly or without making reasonable inquiry vote in favor of the illegal dividend, but also provides for a remedy *by the corporation* against shareholders who receive any such dividends. The liability of the director and of the shareholder respectively is *to the corporation.* Thus instead of being an obligation between directors and creditors alone, the corporation is the party protected by the

statute and is likewise the party prohibited from making the payment of dividends under certain circumstances.

Consequently, if we accept the *Crane Johnson* decision as law and apply it to corporations in the State of Washington, we reach the result that the charter of the corporation consists of the Articles of Incorporation and the laws applicable thereto, and that in the State of Washington there is a provision expressly dealing with dividends, prohibiting the *corporation* from making such payment under conditions such as existed here.

The Eighth Circuit held in *Jones* v. *Mo. Edison Elec. Co.*, 144 Fed. 765, at 770:

> "The relation of a stockholder to his corporation, to his officers and to his co-stockholders is one of contract and of confidence. By the acceptance of his shares of stock, he agrees to assume the liabilities and discharge the duties imposed upon a stockholder by the law. The statutes, the charter, and the by laws of the corporation, *as well as the settled law of the land at the time he takes his stock, are read into, and become a part of his agreement.* The provision of the statutes of Missouri that a manufacturing corporation might be consolidated with another corporation whose objects and business were of the same nature, upon the consent of three-fifths of the owners of its stock, was a *part of the agreement* of the complainant and a consolidation made by the officers and the owners of the requisite amount of the stock of his corporation, by the faithful exercise of the powers thus granted was neither void in itself nor voidable at his option, because it was but *the performance of the agreement which he made with them.* • • •"

By the same token, the contract between the stockholders, the state, and the corporation in the intant case expressly provided against the payment of dividends *by the corporation* under certain circumstances. This contract was in writing. The articles of incorporation and the certificate were written, and by the decisions cited, the laws of the state and the state statutes "are read into" and become "a part of" that "agreement." Distinguished from the North Dakota statute, the Washington statute places the prohibition directly upon the

corporation, and by accepting the charter and issuing stock, the corporation necessarily agrees that *it* will not distribute dividends under certain conditions.

We submit that the *Crane Johnson* opinion must be considered in the light of the North Dakota statute which it interpreted, which statute is distinctly different from the Washington statute in that the relation in North Dakota is between the creditor and the directors, whereas under the Washington State statute the prohibition is directly and expressly against the corporation. Therefore, the premise from which the court proceeds to a conclusion in the North Dakota case does not exist under the law of the State of Washington.

Assuming, however, that the two state statutes were identical, we then submit that the *Crane Johnson* decision should not be followed by this court, for the following reasons:

(1) The decision is in error in holding that section 26 (c) (1) is a credit provision to be strictly construed. On the contrary, it is a relief provision which should be construed liberally. The rule of construction is that a relief provision is to be liberally construed to afford the relief it was intended to provide.

Helvering v. *Bliss*, 293 U. S. 144, 151;
Kelly Springfield Tire Co. v. *U. S.*, 81 F. (2d) 533, 535 (C. C. A.-3);
Cochran v. *Commr.*, 78 F. (2d) 176, 179 (C. C. A.-4);
In re Johnston, 33 B. T. A. 551, 553.

We further note with interest the quotation in respondent's brief from the Senate report, No. 2156, 74th Congress, 2d Session, pp. 12-13, 15, in which, relative to Section 26, it is stated:

> "Contracts not to pay dividends: This credit is in principle *similar to a relief provision* allowed in the House Bill for the purpose of the undistributed profits tax imposed by that bill."

This clearly indicates an intention that the section should be construed liberally as a relief provision.

Even if we were to assume that this provision was in the nature of an exemption, still it would not be strictly construed against the taxpayer.

In *U. S.* v. *Merchants Natl. Trust & Savings Bank*, 101 F. (2d) 399 (C. C. A. 9), decided this year, it is stated:

> "We are conscious of a former principle in construing exemptions in a taxing act of transactions otherwise taxable as here, where the shares are transferred by operation of law, that ambiguities must be construed against the taxpayer. * * * We take it that this has been overruled and that the court is now to exercise the function of 'resolving doubts' in construing all tax legislation."

Secondly, the court overlooked the fact that a stock certificate issued to a shareholder constitutes a written contract, into which the written provisions of the state law are read as if fully set out therein. *In re Culbertsons*, 54 F. (2d) 753 757 (C. C. A. 9). This court stated in that case:

> "This statutory condition imposed upon the right or privilege of calling in or redeeming preferred stock although not expressed in the retirement provisions of any of the certificates here involved, is upon a familiar legal principle to be read into those provisions."

See also:

Hammond & Co. v. *Hastings*, 134 U. S. 401.

With respect to War Risk insurance policies the Supreme Court stated:

> "The terms of these contracts are to be found in part in the policy and *in part in the statutes* under which they are issued and the regulations promulgated thereunder." *Lynch* v. *U. S.*, 292 U. S. 571, 577.

The instant contract was executed by the corporation and a provision thereof (the statute) made as clearly a part of the agreement as if it had been stated therein, expressly deals with the payment of dividends. Had that provision been written as a paragraph of the articles of incorporation, obviously it would conform to the requirements of 26 (c) (1). There is no real difference between making it a part of the contract by a written paragraph therein, and making it a part of the contract by operation of law. It is as binding in the one instance as in the other and all that the statute here in question requires is

that the provision "expressly deals" with the payment of dividends.

Respondent refers to legislative history of the act. Unless words of a statute are ambiguous, no resort may be had to legislative history.

Helvering v. *City Bank Farmers Trust Co.*, 296 U. S. 85, 89;

Minnesota Tea Co. v. *Commr.*, 76 Fed. (2d) 797 (C. C. A.-8).

We notice at page 12 of respondent's brief an argument based upon the legislative history of the act, which implies that the Act is ambiguous. Yet, at page 21 of respondent's brief, it is insisted that the taxpayer is not entitled to the benefits of the usual principle that in case of doubt the statute will be construed in favor of the taxpayer, because as respondent argues, this act is "plain" in its meaning when applied to the facts in the instant case. Thus respondent resorts to legislative history notwithstanding that it is well settled that, unless there is ambiguity, the legislative history has no part in the court's consideration of the statute, but argues against resolving the construction of the statute in favor of the taxpayer because the statute is "plain."

So far as the legislative history is concerned, it is not particularly helpful because the reports of both the Senate and House committees and the discussion on the floor of the House and Senate were addressed to a different bill than that which finally emerged from the conference committee which met subsequent to those reports and discussions.

> "The House and Senate 1936 bills were dissimilar in general aim, theory, and in structure. The 1936 Act as finally enacted was to a considerable extent written in conference without any new statement of legislative intent —a fact which contributes in no small measure to the difficulty of interpretation of the Act." *Paul & Mertens*, "Law of Federal Taxation," 1938 Cum. Supp., Vol. 3, ¶32A.05.

The reference to Senator W[illegible] statement has no importance because he was not in ch[illegible] of the bill and his state-

ment could not be considered even if it were permissible to resort to legislative history.

See:

Duplex Printing Press Co. v. *Deering*, 254 U. S. 443, 474;

Lapina v. *Williams*, 232 U. S. 78, 90;

U. S. v. *Trans Missouri Freight Assoc.*, 166 U. S. 290, 318.

We shall note a portion of respondent's argument under this heading in a subsequent portion of this brief.

The legislative history does not aid because the discussions were relative to a different bill and we do not have the benefit of the reasons for changes made in the committee. It may well be that the lawyers on the Committee realized that in the light of the well known principle of law that a charter is a contract and that the state law is part of the charter, such contract would come within Section 26 (c) (1). If the discussions indicate anything, it is that 26 (c) is a relief provision; thus it is to be liberally construed.

III.

Is the Act Unconstitutional?

Respondent states:

> "Clearly Congress did not intend that the right to the credit should depend upon or vary in accordance with state laws. * * * There is no expression or implication in Section 26 (c) (1) which would require allowance of the credit in one state and disallowance in another, depending upon their peculiar laws respecting dividend payments. On the other hand, Congress clearly had in mind and intended to establish a uniform rule which would operate *without regard to state laws.*" (R. Br., pp. 20, 21.)

Thus respondent concedes that Congress intended not to respect the provisions of law of the several states with respect to the management of corporations.

> "Incidental regulation of such practice by Congress through a taxing act can not extend to matters plainly

inappropriate and unnecessary to reasonable enforcement of a revenue measure. * * *" *Linder* v. *U. S.*, 69 Law. ed. 819, 823, 268 U. S. 5, 17.

It is the law of Washington that dividends paid in impairment of capital are illegal. *Sparling, Trustee* v. *General Discount & Mtge. Corp.*, 178 Wash. 663, 670, 35 P. (2d) 60. Thus Congress would tax a corporation because it did not perform an illegal act. This is a matter plainly inappropriate and unnecessary to reasonable enforcement of a revenue measure. The cases cited by respondent are to the point that "Congress in raising revenue has incidental power to defeat obstructions to that incidence of taxes which it chooses to impose," but this is far from holding that Congress has the power to regulate the corporations of the various states so that they must either commit an illegal act under state law or submit themselves to a heavy Federal tax. Respondent relies on *Helvering* v. *Nat. Grocery Co.*, 304 U. S. 282, and *Willcutts* v. *Milton Dairy Co.*, 275 U. S. 215, 220. In the former case, the federal taxing provision imposed a tax upon net income of a corporation used for the purpose of evading imposition of surtax on its shareholders—quite a different principle than taxing a corporation because that corporation refuses to commit an illegal act. In the *Milton Dairy* case, it is held that tax on net income is proper though there is an impairment of capital, but no reference is made to State law. In *United Business Corp.* v. *Commissioner*, 62 F. (2d) 754 (C. C. A. 2), a corporation was being used to avoid taxes. This was also the case in *Armour Securities Co.* v. *Comm'r*, 91 F. (2d) 427 (C. C. A. 5).

Plainly a line against regulation must be drawn somewhere, and it is simply absurd to argue that the Federal Government is not in effect regulating corporations when it imposes an onerous tax based upon inability of the corporation under the State law to pay a dividend.

Respondent attempts to justify this by stating that Congress may pass measures reasonably calculated to prevent avoidance of tax. Wherein is there an attempt to prevent an avoidance of taxes when the Federal officers are conclusively presumed to know what the state laws are?

Respondent, when arguing as to the distinction between oral and written contracts, says (page 28 of his brief):

> "It is a comparatively easy matter for the Bureau of Internal Revenue to ascertain whether an ordinary written contract prohibits payment of dividends."

If this is true, why it is not a comparatively easy matter also for the bureau to determine whether or not the law of a particular state prohibits the payment of dividends? It is submitted that the argument of reasonableness of the regulation is wholly wanting in force and that the act constitutes an invasion of the state powers of regulation of its corporations and if carried to its logical ends would destroy that state power.

Respondent refers to our argument that the tax constitutes a penalty. As stated in our opening brief, the tax is not on income at all, but is dependent upon what the taxpayer does with its income already taxed. The undistributed profits tax in reality is not an income tax, nor is it an excise tax, for it arises only as a condition of what the taxpayer does with income already taxed. See:

Eisner v. *Macomber*, 64 Law. ed. 521, 252 U. S. 189.

With respect to the distinction drawn between written and oral contracts, respondent argues that since deductions are discretionary, appellant can not complain. However, assuming deductions are discretionary, still a tax must be within constitutional limits. Respondent argues that the distinction is upon a rational basis because of the added difficulty of determining the validity and scope of oral contracts. This argument is used by respondent, however, in connection with charter provisions and state laws. Yet, state law must be given consideration by internal revenue officials in many instances, as illustrated in *Lang* v. *Comm'r*, 204 U. S. 264, and *Blair* v. *Comm'r*, 300 U. S. 5.

It is no more difficult for Federal departments to ascertain the state law applicable to a particular contract than it is for a taxpayer to ascertain the Federal law, and the taxpayer is confronted with treasury rulings in many instances directly contrary to court decisions. We have noted no disposition on

the part of the Treasury Department to evince sympathy for the taxpayer because of the maze of regulations which that Department issues or to contend that because of the difficulties involved the regulations are unreasonable.

It is argued by respondent that practical considerations must prevail. It is clear, however, that by "practical considerations," respondent is thinking of but one thing—claimed difficulty of enforcement. The Constitution should not bend to legislation because that legislation eases the burden of the taxing official though it is impossible for the taxpayer legally to make the distribution which the taxing act was designed to cause taxpayer to pay out. If practical considerations are to be weighed, why not consider the taxpayer's dilemma? The State says to taxpayer: "Don't distribute dividends." The Federal Government says: "If you don't, we tax you;" and "We're taxing you, not because you made so much money, but because you are not distributing it, although we know you can't do so because the State prohibits you from doing that."

Conclusion.

The proof of inability to pay the dividend is in the record without objection and respondent can not now complain on that score. To raise that question at this late date is an acknowledgment of weakness as to the other points.

The charter is a written contract and a part of that contract is the state law. A provision of the state law expressly deals with dividends and is as much a part of the charter of the corporation as if it had been written word for word in that charter. Consideration of the legislative history is both unnecessary and lacking in helpfulness. If there is any doubt as to interpretation of the section, that doubt should under well established principle, be resolved in favor of the taxpayer, particularly since this relief provision is to be liberally construed.

If the credit is not given, then the act is unconstitutional, being a wrongful invasion of the power of the states and containing an arbitrary discrimination between written and oral contracts. Furthermore, the so-called "Undistributed Profits

Tax" is in reality nothing more than a penalty, for it is neither excise tax nor income tax, but is dependent upon what the taxpayer does with the income already taxed.

For the reasons stated, no deficiency should be assessed against petitioner.

Respectfully submitted,

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EXHIBIT "D."

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TAXATION AND THE FALL OF THE ROMAN EMPIRE

By ARTHUR E. R. BOAK*

To students of the history of civilization, the fall of the Roman Empire and the accompanying cultural decline of the Mediterranean World has long presented, and still continues to present, a problem of unique fascination. Thirty years ago, however, it would have been rash to assert that in this country at least there was any widespread interest even in educated and intelligent circles in a question which apparently had so little to do with the world in which we then lived. An all pervading belief in the doctrine of continuous progress and a sublime confidence in the solidity of the foundations of modern society had produced a certain indifference, tinged with contempt, towards peoples of the past who had not been able to solve the problems of their own time or preserve their states and their civilization. But today the situation is different. The universal economic and political confusion which has prevailed since the World War and the realization that another conflict of this type might produce a collapse of European civilization have undermined the general faith in the stability of our own social structure. As is only natural, this attitude of mind has caused thoughtful people to scan more closely the past experi-

*Professor Arthur E. R. Boak in his discussion of *Taxation and the Fall of the Roman Empire* makes no comparisons. Nevertheless, as Chairman of the Department of History in the University and an authority on the governmental institutions of the Roman Empire, he sets down some facts which have a certain significance today. This article formed Professor Boak's presidential address at the meeting of the Michigan Academy of Science, Arts, and Letters in Ann Arbor, March 17. In the preparation of this paper Professor Boak wishes to acknowledge the helpful suggestions of Professor Max Handman, of the Department of Economics.

ence of the human race to see where similar crises have occurred and from what conditions they have arisen.

Doubtless many are familiar with various theories which have been advanced to account for the decline of the Roman Empire. They include waning morality, Christianity, soil exhaustion, decrease in population, inadequate methods of production and distribution, and the extermination of the abler elements as a result of war and political persecution. There is no doubt that some of these played a part, perhaps a large one, in the general picture. I must emphasize, however, that today no serious student of the period believes that the fall of Rome, which involved the collapse of ancient civilization, can be explained in terms of one single cause. It is also unanimously agreed that the breakdown came from within rather than from without; in other words, it was not the increasing power of the barbarians but the declining power of the Roman world which made possible the penetration and occupation of the western part of the Empire by the Germanic peoples from central and northern Europe. In attempting to explain the growing weakness of the Roman state, it seems to me that historians have not stressed sufficiently the part played by the increasing cost of government or, to state it somewhat differently, the increasing burden of taxation.

In the first and second centuries after Christ the Roman Empire enjoyed its greatest prosperity. It stretched from Scotland to the Arabian Desert, and from the Sahara to the basins of the Rhine and the Danube. Its area was about 3,500,000, square miles; its population between 50,000,000 and 60,000,000. For governmental purposes, the Empire was divided into a number of large districts called provinces, and these in turn were subdivided into smaller units, usually organized as municipalities with local autonomy. Local government constituted a charge upon the local property holders. Municipal offices were unsalaried and were open only to those who had a definite property qualification. If a sufficient number of qualified candidates did not present themselves at the annual election, candidates could be drafted from the qualified class. Ex-magistrates became town councillors for life without salary. In Egypt, prior to the introduction of the municipal system

in the third century, local officials were appointed from the propertied class by the provincial authorities.

Thus the effective maintenance of local government constituted an indirect tax upon property. Provincial government was conducted by a governor and a group of subordinate officials sent from Rome to administer justice and collect the taxes imposed by the imperial government. At Rome itself existed a number of central administrative bureaus which controlled the activities of the provincial administration. This superstructure of provincial and imperial government was supported by taxation, levied largely upon the provinces and collected by imperial or local agents in the municipal or other local administrative units. We do not need to concern ourselves greatly with the individual taxes, except to say that they included most of the forms which are familiar to us—property taxes, poll taxes, sales taxes, inheritance taxes, and tariffs. *But one aspect of Roman imperial finance differed markedly from that of modern governments; namely, that no system of floating government loans by bond issues was known.* Thus extraordinary expenses must be met by direct levies and *the burden could not be passed on to coming generations.* On the other hand, the Roman government could requisition on its own terms both supplies and services from the people of the Empire, over and above the normal load of taxation. Such requisitions must be regarded as a special form of taxation.

In the period under consideration, that known as the Principate, the Roman government had definitely abandoned the policy of exploiting the provinces for the benefit of the governing classes and moneyed interests of Rome, which had prevailed under the Republic. Although at first Italy occupied a favored position within the Empire, this superiority gradually disappeared. The extension of Roman citizenship to the provincials and the admission of Romans of provincial birth to the imperial aristocracy and the principate itself were outstanding factors in this process of assimilation. The Roman government realized that the prosperity of the Empire depended upon the prosperity of the provinces and strove to promote their economic well-being, fostering in particular the organization of new municipal units and expanding the class

of independent landholders. *Under the aegis of Rome peace prevailed, agriculture flourished, trade and industry expanded, until by the middle of the second century* A.D. *the ancient Mediterranean World reached the height of its material prosperity.*

In the meantime, however, the imperial government *became increasingly autocratic and more and more highly centralized.* The interests of the state completely overshadowed all other interests—provincial, municipal and individual. The preservation of the Empire became the ultimate goal of public policy. At the same time the imperial government extended its functions and increased its administrative machinery, thus laying an increased burden upon the taxpayers which more than counterbalanced the general rise in prosperity. The creation of the imperial government service with its numerous departments and its permanent paid officials; the development of the imperial post; the construction of public works on a generous scale; the elaboration of the system of doles and entertainments for the populace of the capital; the support given to education, public health, and Italian farm relief; and the increase in the military establishment necessitated by problems of frontier defence combined to raise the cost of government far above its figure at the outset of the Principate. So precarious was the financial situation, that a protracted war or a spendthrift emperor threatened to cause, and at times actually did cause, bankruptcy of the treasury.

We have many bits of evidence to show that the cost of the government of the Empire strained the taxpaying power of its populace. Lack of m o n e y was one of the reasons for abandoning the attempt to secure the northern frontier by occupying the region between the Rhine and Elbe, and for surrendering to the Arthians the eastern conquests of Trajan in Armenia and Mesopotamia. The burden of taxation played a part in causing the rebellion in Judaea in A. D. 66. At his accession the emperor Hadrian found arrears of taxation going back over fifteen years and thought it advisable to remit these. But the same emperor added to the imperial service the numerous advocates of the fiscus whose duty it was to prosecute the claims of the treasury a g a i n s t delinquents. Marcus Aurelius, whose principate followed the peaceful period of Antoninus Pius, had to follow Hadrain's example in

remitting arrears of taxation and had to meet repeated requests from the municipalities for financial support or for reduction of tax quotas. The same emperor expressed with brutal frankness the desperate condition of the public finances when he answered the petition of his victorious troops for an increase in pay with the words: "Anything you receive in excess of your regular stipends must be exacted from the blood of your parents and relatives."

It is from Egypt, however, that we derive our clearest evidence of the cost of imperial government to the individual provinces. Although Egypt was exploited more thoroughly for the benefit of the imperial treasury than the other provinces of the empire, it was by no means the intention of the government to ruin its people (as Tiberius put it, the governor should "shear the sheep, not flay them"), but rather to cause them to prosper so that they could produce more revenue. Hence, if taxation proved too heavy, it meant that the combined weight of local and imperial administration was greater than even this rich area could support. Already by the middle of the first centrury A.D. serious complaints of fiscal oppression appeared. The Roman administration was as strict with the tax collectors as with the taxpayers. It required the former to offer their properties as security for the sum total of taxes which they were to collect. Hence the tax officers employed every means in their power, legal or illegal, to force the individual taxpayers to contribute the full amount for which they were liable. If a person lacked the means to meet his quota, his relatives or even his fellow townsmen and villagers were forced to make good the deficit. The demands of the collectors were enforced with brutal violence and at times soldiers were called upon to coerce those who failed to meet them. In times of poor harvests, farmers who could not pay their taxes took to flight, leaving their lands untilled for the next season. Between the years A.D. 55 and 60 the collectors of the poll tax in a group of villages in the Fayum reported that their population, "once numerous," had shrunk to a few individuals as many had absconded owing to their lack of means to meet the taxes and others had died leaving no relatives (P. Graux 2). At about the same time, in another village of the same area, over forty propertyless run-aways were reported for two successive years as being in arrears with poll and dyke

taxes, and in the second year fifty-four others as having left for parts unknown to avoid their public obligations (P. Cornell 24, and P. Ryl. Inv. no. 823; H. I. Bell, "The Economic Crisis in Egypt under Nero," *J. R. S.*, 1938, pp. 6-7).

In spite of all attempts of governors and even emperors to curb illegal exactions and to improve the condition of the tillers of the soil, the situation gradually grew worse. The necessities of the government prevented any material alleviation of the tax load. More and more peasants refused to lease public lands because the burdens involved were too heavy, and in order to prevent loss of revenue from this source the government assigned the unleased plots to adjacent villages or private landowners who thereby became responsible for their cultivation and the payment of taxes thereon. This put an even heavier burden on those who remained and the flight of the peasants assumed ever larger proportions, and led to the armed revolts of A.D. 152 and 172.

But it was not only the tenant farmers who suffered under this system. Landowners and townsmen were affected also. At first the Romans had employed salaried officials in the administration of Egypt, following the custom of their predecessors, the Ptolemies. But in the latter part of the first century A.D. they resorted to the practice of drafting the officials from the propertied classes of the towns and villages. These appointees served without salary, and such service constituted an additional tax upon their properties. In resorting to this method of recruiting their administrative and police personnel, the Romans were not altogether innovators. Rather, they seized upon the well-known Greek institution of *liturgies* or obligatory public services imposed upon well-to-do persons, but applied it on a scale unexampled hitherto. As the office-holders were responsible with their properties for any deficits in the collections which they had to make, they were merciless in exacting full payment from the helpless peasants. But when the latter took refuge in flight, the burden fell back upon the officials. How frequently flight from the land or confiscation and sale of property to meet fiscal obligations occurred in Egypt during the second century A.D. may be judged from the fact that two of the stock questions addressed to the gods by those who sought heavenly guidance in their mundane af-

fairs were: (1) Shall I run away? and (2) Am I going to be sold out? (V. Martin, *La fiscalité romaine en Egypte*, p. 28.)

In the other provinces of the Empire, we can trace the growing burden of government demands in the increasing resort to requisitons and special levies on the one hand, and on the other in the growth of the principle of personal responsibility on the part of municipal officials for the raising of imperial revenues. By the close of the second century A.D. the holding of municipal offices had become a definite obligation on the part of persons of property. In the eastern cities committees of ten members nominated by the local councils from among the more prosperous citizens, were put in charge of collecting the imperial revenues from their municipal territories. These *dekaprotoi* or 'first ten,' as they were called, became responsible with their properties for any deficiencies in the municipal quotas. The *dekaprotoi* were introduced into Egypt at the beginning of the third century. Here municipal councils were created in the district capitals and charged with the responsibility for the financial administration of the towns and for nominating and acting as sureties for both municipal and state offcials (H. I. Bell, in *C. A. H.* XI, p. 657).

In general, it seems fair to say that by the opening of the third century the cost of conducting both local and imperial government combined with the method of collection had reduced the agricultural population to a precarious situation and had made serious inroads upon the capital wealth of the municipal propertied class which constituted the middle class throughout the Empire as a whole. The resort of the imperial government to systematic and continuous debasement of the coinage from this time onward for over half a century is additional and striking evidence of its inability to meet its expenses by known methods of taxation. When the threefold scourge of civil war, foreign invasion, and plague ravaged the empire between A.D. 235 and 284, the ordinary revenues grew steadily smaller and the emperors were forced to resort to desperate measures to finance their wars and satisfy the demands of the mutinous soldiery. The properties of the supporters of their rivals were confiscated; municipal endowments met the same fate; requisitions of crops, draft animals, other supplies, and personal services were endless.

When comparative peace and order were restored to the Empire by the time of the accession of Diocletian (A. D. 284), the general economic condition was much weaker than it had been at the opening of the third century. Population had declined greatly, large areas had become unproductive owing to lack of agricultural workers and the ravages of war, commerce and industry had sunk to a low ebb, and much capital wealth in the form of buildings, farm animals, etc., had been destroyed. As a result, the taxpaying power of the population was greatly reduced, as in the case of a severe economic depression. Do we find, then, a corresponding attempt to decrease the cost of local and imperial government so as to adjust the tax burden to the capacity of the people to pay? The answer is: "By no means." On the contrary, the military establishment was increased, there was a tremendous expansion of the civil service, and a much more elaborate and costly court ceremonial was adopted. The doles and entertainments provided for the Roman mob were duplicated in the new eastern capital Constantinople. In addition to this, all the old municipal offices with their liturgical obligations were revived and had to be supported as before by the municipal propertied class (C. E. van Sickle, "Diocletian and the Decline of the Roman Municipalities," *J. R. S.*, 28 (1938), pp. 9-18). The principle that the civilian population should toil for the support of the government was definitely accepted and the system of taxation was revised with this end in view.

All farm land was classed as grain land, orchard land, or pasture land. The land of each class was divided into units of approximately equal productive capacity and each unit paid an equal tax in kind at a rate announced by the government in advance for each year. In parts of the Empire, the agricultural workers were also grouped into tax units and paid a poll tax in kind. The other taxes levied upon those engaged in trades and business were collected in money. At the same time, the practice was introduced of paying government employees wholly or partly in allowances of natural products. This step was not taken because of a shortage of precious metals or because of instability of the coinage as has often been assumed. Both the gold and the silver coinage had been put on a sound basis by the monetary reforms of Diocletian and Constantine and they remained stable on this basis until late in the Byzantine Empire. And the bronze coinage, although not so satis-

factory, did not suffer any great fluctuations in value. In private business transactions money economy continued to hold the field against natural economy, and at various times the government showed itself to be possessed of large sums of gold which it expended for purposes of state. The collection of taxes in kind was intended partly to supplant the irregular levies on agricultural produce which had proved such a burden to the producers, and partly to protect the government against loss in case of future inflation or price fluctuation. At the same time, the officials who received salaries in kind were secured against loss through rise in prices and could actually profit when there was a shortage of foodstuffs by selling their surplus receipts at the high market rate. The persons who suffered were the rural taxpayers. If there was an abundant crop and prices were low, they paid their taxes in kind and had to market any surplus at the prevailing low price, but if there was a shortage they could not profit by the current high prices, and in case they were unable to furnish their tax quota in produce they had to make up the deficit in cash at the official market rate.

The adoption of a general land tax in kind completed the ruin of the tenant farmers. Their landlords who must pay the tax insisted on fixed rentals in kind. This system, which took no account of annual variations in crops, led to the tenants becoming indebted to their landlords to such an extent that they abandoned their personal property, threw up their contracts, and left the farms. In answer to the appeals of the landholders who could not pay the property tax if their fields were not tilled, the government intervened and attached the tenants and farm laborers to the estates in the status of serfs. Another consequence of the collection of the taxes and the payment of government employees in kind was the compulsory enrollment of all those who were engaged in the transportation, processing and distribution of these products in hereditary corporations. Under the Principate the government had relied at first upon individual initiative for the handling of government supplies. But as the needs of the state grew and extraordinary requisitions were resorted to with increasing frequency, the government began to draft the services of shipowners and others to cope with the greater volume of produce which required transport by sea and land. To compensate such persons for the loss which they incurred from

their services to the state, they were encouraged to enroll in guilds whose members were granted appreciable privileges and immunities. Under the Autocracy of Diocletian and his successors the further increase in state income in natural products, coupled with the decline in numbers and wealth of the membership of the guilds engaged in shipping and distributing, led the state to take more drastic measures to ensure the performance of public services. The handling of government supplies was made a permanent charge upon capital invested in business of this sort irrespective of transfer of ownership. Finally, when men began to give up such property because of the burdens associated with it, the obligation was made personal as well as real. All those enrolled in the guilds of shippers, millers, bakers, wine, oil and meat dealers and the like, became hereditary members of these corporations, passing on their public responsibilities from one generation to the next (for this interpretation of the economic developments, see in particular G. Mickwitz, *Geld und Wirtschaft im romischen Reiche des vierten Jahrhunderts).*

In the light of what happened to the peasantry and those who were engaged in the transportation and distribution of natural produce, it is not surprising to find that a similar fate overtook the class of proprietors from which the municipal councillors were recruited. Under the new system the councils were nothing more than agencies for the collection of taxes from the municipal territories operating through the municipal officers. The combination of imperial and municipal obligations which weighed upon them proved a crushing load. In order to make sure that the state had these fiscal agents at its disposal all persons who possessed a stated minimum of property automatically became members of their local municipal councils. As in earlier days, the property of the local officials was held as security by the state for any deficit in the amount of the taxes they should collect or other duties they should perform. We can well understand that in their despair over the possibility of meeting the load imposed upon them many abandoned their properties and tried to find a refuge in the army, the civil service or the clergy. Faced with this situation, the state acted as it had done in the case of the peasants and the members of the corporations; it made the town councillors an hereditary class. In their anxiety to meet the de-

mands of the fiscal agents of the state the municipal officers pressed hard upon their own tenants, the tenants of municipal land and others within the municipal tax areas. With this conduct in mind we can appreciate the dictum of a fourth century writer: "Every councillor is a tyrant."

There was one group of persons, however, who defied successfully the demands of local and government tax agents alike. These were the great landed proprietors who formed the highest official class in the Empire and did not hesitate to use their political influence for their economic advantage. They had profited greatly by the imperial policy of encouraging the occupation of uncultivated public lands and now took under their protection, as serfs, the villagers and even town councillors who transferred their lands to them in order to mitigate their tax burdens. Since this form of patronage involved a loss to the state, it was opposed by the emperors to the best of their ability but they had to yield in the end. By the early fifth century, the great proprietors were exempted from the authority of municipal officers and granted the privilege of collecting the taxes themselves on their own great domains.

It was in the fifth century that the fruits of the tax system of the Late Empire were reaped in full. The municipal proprietors as a class had almost completely disappeared. In all the western provinces of the Empire, there was hardly one who had enough property to fulfill the obligations of his order. The imperial post had to be abandoned for lack of persons abie to meet the requisitions for transport animals and vehicles. The peasantry had been reduced to serfdom on state lands or large private estates. These conditions led to a steady decrease in the public revenues, and nothing reveals the low ebb of the state finances more clearly than the great difficulty which the government experienced in raising armies which were mere fractions of the supposed military establishment. Under conditions such as these we can readily understand how the Teutonic tribes, settled at first as Roman allies within the Empire, gradually shook off their allegiance and took over the government of Italy and the western provinces without encountering any serious opposition from the helpless civilian population.

From the foregoing presentation, it should, I believe, be abundantly clear that the system of taxation played a prominent role in the disintegration of the Roman Empire and the economic collapse of ancient society. It violated each of the four canons of taxation laid down by Adam Smith in his famous *Wealth of Nations:* (1) equality in distribution, (2) certainty in amount, (3) convenience in payment, and (4) economy in collection. The Roman taxes, particularly in the Late Empire, may well have been too heavy in themselves, although this is more difficult to prove in view of our ignorance both of the total income of the taxpayers and the total amount levied. However that may have been, under the methods of collection resorted to they proved a crushing burden.

The implications of this transcend a mere interest in analyzing the causes of what we may well regard as the ultimate failure of a great and long-sustained human effort to create and maintain a satisfactory way of living. They point to two general conclusions. One, that in any large state there is grave danger that the combination of local and central government agencies will develop into a load which will outgrow the taxpaying power of the people, particularly if the taxes are assessed and collected in defiance of sound principles of political economy. And, two, that, when the maintenance of any existing form of government takes precedence over the economic interests of those who support it, that government is paving the way for its own undoing.

EXHIBIT "E."

REVENUE ACT 1936
Italics indicate new matter.

Sec. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) DEFINITIONS.—*As used in this title—*

(1) The term "adjusted net income" means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

(C) In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933), the amount allowed as a credit under section 26 (d).

(D) In the case of a national mortgage association created under Title III of the National Housing Act, the amount allowed as a credit under section 26 (e).

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) IMPOSITION OF TAX.—*There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):*

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net

income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

17 per centum of the portion of the undistributed net income which is in excess of 20 per centum and not in excess of 40 per centum of the adjusted net income.

22 per centum of the portion of the undistributed net income which is in excess of 40 per centum and not in excess of 60 per centum of the adjusted net income.

27 per centum of the portion of the undistributed net income which is in excess of 60 per centum of the adjusted net income.

(c) ADJUSTED NET INCOME LESS THAN $50,000.—

(1) SPECIFIC CREDIT.—*If the adjusted net income is less than $50,000, there shall be allowed a specific credit equal to the portion of the undistributed net income which is in excess of 10 per centum of the adjusted net income and not in excess of $5,000, such credit to be applied as provided in paragraph (2).*

(2) APPLICATION OF SPECIFIC CREDIT.—*If the corporation is entitled to a specific credit, the tax shall be equal to the sum of the following:*

(A) A tax computed under subsection (b) upon the amount of the undistributed net income reduced by the amount of the specific credit, plus

(B) 7 per centum of the amount of the specific credit.

(d) EXEMPTION FROM SURTAX.—*The following corporations shall not be subject to the surtax imposed by this section.*

(1) Banks as defined in section 104.

(2) Domestic corporations which for any portion of the taxable years are in bankruptcy under the laws of the United States, or are insolvent and in receivership in any court of the United States or of any State, Territory, or the District of Columbia.

(3) Insurance companies subject to the tax imposed under section 201, 204, or 207.

(4) Foreign corporations.

(5) Corporations which, by reason of deriving a large portion of their gross income from sources within a possession of the United States, are entitled to the benefits of section 251.

(6) Corporations organized under the China Trade Act, 1922.

(7) Joint Stock Land Banks organized under the Federal Farm Loan Act, as amended.

(e) EXEMPT CORPORATIONS. — *For corporations exempt from taxation under this title, see section 101.*

(f) TAX ON PERSONAL HOLDING COMPANIES.—*For surtax on personal holding companies, see section 351.*

(g) IMPROPER ACCUMULATION OF SURPLUS.—*For surtax on corporations which accumulate surplus to avoid surtax on stockholders, see section 102.*

Sec. 26. CREDITS OF *CORPORATIONS.*

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

(a) INTEREST ON OBLIGATIONS OF THE UNITED STATES AND ITS INSTRUMENTALITIES.—*The* amount received as interest upon obligations of the United States or of corporations organized under Act of Congress which is allowed to an individual as a credit for purposes of normal tax by section 25 (a) *(1)* or *(2)*.

(b) DIVIDENDS RECEIVED.—*85 per centum of the amount received as dividends from a domestic corporation which is subject to taxation under this title. The credit allowed by this subsection shall not be allowed in respect of dividends received from a corporation organized under the China Trade Act, 1922, or from a corporation which under section 251 is taxable only on its gross income from sources within the United States by reason of its receiving a large percentage of its gross income from sources within a possession of the United States.*

(c) CONTRACTS RESTRICTING PAYMENT OF DIVIDENDS.—

(1) PROHIBITION ON PAYMENT OF DIVIDENDS.—*An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.*

(2) DISPOSITION OF PROFITS OF TAXABLE YEAR.—*An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.*

(3) DOUBLE CREDIT NOT ALLOWED.—*If both paragraph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.*

(d) BANK AFFILIATES.—*In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933), the amount of the earnings or profits which the Board of Governors of the Federal Reserve System certifies to the Commissioner has been devoted by such affiliate during the taxable year to the acquisition of readily marketable assets other*

than bank stock in compliance with section 5144 of the Revised Statutes. The aggregate of the credits allowable under this subsection for all taxable years shall not exceed the amount required to be devoted under such section 5144 to such purposes.

(e) NATIONAL MORTGAGE ASSOCIATIONS.—*In the case of a national mortgage association created under Title III of the National Housing Act, the amount of the earnings or profits which the Federal Housing Administrator certifies to the Commissioner has been devoted by such association during the taxable year to the acquisition of such reserves as the Administrator may require under the provisions of section 303 of that Act.*

Sec. 27. CORPORATION CREDIT FOR DIVIDENDS PAID.

(a) DIVIDENDS PAID CREDIT IN GENERAL.—*For the purposes of this title, the dividends paid credit shall be the amount of dividends paid during the taxable year.*

(b) DIVIDEND CARRY-OVER.—*In computing the dividends paid credit for any taxable year, if the dividends paid during the taxable year are less than the adjusted net income, there shall be allowed as part of the dividends paid credit, and in the following order:*

(1) Dividends paid during the second preceding taxable year in excess of the adjusted net income for such year, to the extent not needed as a dividends paid credit for the taxable year preceding the taxable year the tax for which is being computed; and

(2) Dividends paid during the first preceding taxable year in excess of the adjusted net income for such year.

No credit shall be allowed for dividends paid by a corporation prior to its first taxable year under this title.

(c) DIVIDENDS IN KIND.—*If a dividend is paid in property other than money (including stock of the corporation if held by the corporation as an investment) the dividends paid credit with respect thereto shall be the adjusted basis of the prop-*

erty in the hands of the corporation at the time of the payment, or the fair market value of the property at the time of the payment, whichever is the lower.

(d) DIVIDENDS IN OBLIGATIONS OF THE CORPORATION.—*If a dividend is paid in obligations of the corporation, the amount of the dividends paid credit with respect thereto shall be the face value of the obligations, or their fair market value at the time of the payment, whichever is the lower. If the fair market value is lower than the face value, then when the obligation is redeemed by the corporation, the excess of the amount for which redeemed over the fair market value at the time of the dividend payment (to the extent not allowable as a deduction in computing net income for any taxable year) shall be treated as a dividend paid in the taxable year in which the redemption occurs.*

(e) TAXABLE STOCK DIVIDENDS.—*In case of a stock dividend or stock right which is a taxable dividend in the hands of shareholders under section 115 (f), the dividends paid credit with respect thereto shall be the fair market value of the stock or the stock right at the time of the payment.*

(f) DISTRIBUTIONS IN LIQUIDATION.—*In the case of amounts distributed in liquidation the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, shall, for the purposes of computing the dividends paid credit under this section, be treated as a taxable dividend paid.*

(g) PREFERENTIAL DIVIDENDS.—*No dividends paid credit shall be allowed with respect to any distribution unless the distribution is pro rata, equal in amount, and with no preference to any share of stock as compared with other shares of the same class.*

(h) NONTAXABLE DISTRIBUTIONS.—*If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, no dividends paid credit shall be allowed with respect to such part.*

Sec. 102. SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.

(a) IMPOSITION OF TAX.—There shall be levied, collected, and paid for each taxable year *(in addition to other taxes imposed by this title)* upon the net income of every corporation (other than a personal holding company as defined in section 351) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting *earnings or* profits to accumulate instead of being divided or distributed—

(1) In the case of corporations not subject to the surtax on undistributed profits imposed by section 14, a surtax equal to the sum of the following:

25 per centum of the amount of the retained net income not in excess of $100,000, plus

35 per centum of the amount of the retained net income in excess of $100,000.

(2) In the case of corporations subject to the surtax on undistributed profits imposed by section 14, a surtax equal to the sum of the following:

15 per centum of the amount of the retained net income not in excess of $100,000, plus

25 per centum of the amount of the retained net income in excess of $100,000.

(b) PRIMA FACIE EVIDENCE.—The fact that any corporation is a mere holding or investment company, or that the *earnings* or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to avoid surtax *upon shareholders.*

(c) DEFINITIONS.—*As used in this title—*

(1) SPEC'AL ADJUSTED NET INCOME.—*The term "special adjusted net income" means the net income minus the sum of—*

(A) Taxes.—Federal income, war-profits, and excess-profits taxes paid or accrued during the taxable year, to the extent not allowed as a deduction by section 23, but not including the tax imposed by this section or a corresponding section of a prior income-tax law.

(B) Disallowed charitable, etc., contributions.—Contributions or gifts, not otherwise allowed as a deduction, to or for the use of donees described in section 23 (o), for the purposes therein specified.

(C) Disallowed losses.—Losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117 (d).

(D) Bank affiliates.—In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933), the amount allowed as a credit under section 26 (d).

(E) National Mortgage Associations.—In the case of a national mortgage association created under Title III of the National Housing Act, the amount allowed as a credit under section 26 (e).

(2) RETAINED NET INCOME.—*The term "retained net income" means the special adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends. For the purposes of this subsection, such credits shall be computed by substituting in section 26 (c) and in section 27 for the words "adjusted net income" wherever appearing in such sections the words "special adjusted net income."*

(d) PAYMENT OF SURTAX ON PRO RATA SHARES.—The tax imposed by this section shall not apply if *(1)* all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed, or not, of the *retained* net income of the corporation for such year, *and (2) 90 per centum or more of such retained net income is so included in the gross income of shareholders other than corporations.* Any amount so included in the gross income of a shareholder shall be treated as a

dividend received. Any subsequent distribution made by the corporation out of earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his pro rata share, be exempt from tax in the amount of the share so included.

(e) TAX ON PERSONAL HOLDING COMPANIES.—For surtax on personal holding companies, see section 351.

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) DEFINITION OF DIVIDEND.—The term "dividend" when used in this title (except in section 203(a)*(3)* and section 207(c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, *(1)* out of its earnings or profits accumulated after February 28, 1913, *or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.*

(b) SOURCE OF DISTRIBUTIONS.—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

(c) DISTRIBUTIONS IN LIQUIDATION.—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. Despite the provisions of section 117 (a), 100 per centum of the gain so recognized shall

be taken into account in computing net income, *except in the case of amounts distributed in complete liquidation of a corporation. For the purpose of the preceding sentence, "complete liquidation" includes any one of a series of distributions made by a corporation in complete cancellation or redemption of all of its stock in accordance with a bona fide plan of liquidation and under which the transfer of the property under the liquidation is to be completed within a time specified in the plan, not exceeding two years from the close of the taxable year during which is made the first of the series of distributions under the plan.* In the case of amounts distributed (whether before January 1, 1934, or on or after such date) in partial liquidation (other than a distribution within the provisions of subsection (h) of this section of stock or securities in connection with a reorganization) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits.

(d) OTHER DISTRIBUTIONS FROM CAPITAL.—If any distribution (not in partial or complete liquidation) made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not *a dividend*, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property.

(e) DISTRIBUTIONS BY PERSONAL SERVICE CORPORATIONS.—Any distribution made by a corporation, which was classified as a personal service corporation under the provisions of the Revenue Act of 1918 or the Revenue Act of 1921, out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 or section 218 of the Revenue Act of 1921, shall be exempt from tax to the distributees.

(f) STOCK DIVIDENDS.—

(1) GENERAL RULE.—*A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder*

within the meaning of the Sixteenth Amendment to the Constitution.

(2) ELECTION OF SHAREHOLDERS AS TO MEDIUM OF PAYMENT.—*Whenever a distribution by a corporation is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either (A) in its stock or in rights to acquire its stock, of a class which if distributed without election would be exempt from tax under paragraph (1), or (B) in money or any other property (including its stock or in rights to acquire its stock, of a class which if distributed without election would not be exempt from tax under paragraph (1)), then the distribution shall constitute a taxable dividend in the hands of all shareholders, regardless of the medium in which paid.*

(g) REDEMPTION OF STOCK.—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

(h) EFFECT ON EARNINGS AND PROFITS OF DISTRIBUTIONS OF STOCK.—*The distribution (whether before January 1, 1936, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities or stock or securities in another corporation shall not be considered a distribution of earnings or profits of any corporation—*

(1) if no gain to such distributee from the receipt of such stock or securities was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

(i) DEFINITION OF PARTIAL LIQUIDATION.—As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

(j) VALUATION OF DIVIDEND.—*If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder.*

Sec. 117. CAPITAL GAINS AND LOSSES.

(a) GENERAL RULE.—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 1 year;

80 per centum if the capital asset has been held for more than 1 year but not for more than 2 years;

60 per centum if the capital asset has been held for more than 2 years but not for more than 5 years;

40 per centum if the capital asset has been held for more than 5 years but not for more than 10 years;

30 per centum if the capital asset has been held for more than 10 years.

(b) DEFINITION OF CAPITAL ASSETS.—For the purposes of this title, "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(c) DETERMINATION OF PERIOD FOR WHICH HELD.—For the purpose of subsection (a)—

(1) In determining the period for which the taxpayer has held property received on an exchange there shall

be included the period for which he held the property exchanged, if under the provisions of section 113, the property received has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged.

(2) In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, if under the provisions of section 113, such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

(3) In determining the period for which the taxpayer has held stock or securities received upon a distribution where no gain was recognized to the distributee under the provisions of section 112(g) of the Revenue Act of 1928 or the Revenue Act of 1932, there shall be included the period for which he held the stock or securities in the distributing corporation prior to the receipt of the stock or securities upon such distribution.

(4) In determining the period for which the taxpayer has held stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeductibility (under section 118 of this Act or section 118 of the Revenue Act of 1928 or the Revenue Act of 1932 *or the Revenue Act of 1934*, relating to wash sales) of the loss from the sale or other disposition of substantially identical stock or securities, there shall be included the period for which he held the stock or securities the loss from the sale or other disposition of which was not deductible.

(d) LIMITATION ON CAPITAL LOSSES.—Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges. If a bank or trust company incorporated under the laws of the United States or of any State or Territory, a substantial part of whose business is the receipt of deposits, sells any bond, debenture, note, or certificate or other evidence of indebtedness issued by any corporation (including one issued by a government or poli-

tical subdivision thereof), with interest coupons or in registered form, any loss resulting from such sale (except such portion of the loss as does not exceed the amount, if any, by which the adjusted basis of such instrument exceeds the par or face value thereof) shall not be subject to the foregoing limitation and shall not be included in determining the applicability of such limitation to other losses.

(e) GAINS AND LOSSES FROM SHORT SALES, ETC.—For the purpose of this title—

(1) gains or losses from short sales of property shall be considered as gains or losses from sales or exchanges of capital assets; and

(2) gains or losses attributable to the failure to exercise privileges or options to buy or sell property shall be considered as gains or losses from sales or exchanges of capital assets held for one year or less.

(f) RETIREMENT OF BONDS, ETC.—For the purposes of this title, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

Sec. 351. SURTAX ON PERSONAL HOLDING COMPANIES.

(a) IMPOSITION OF TAX.—There shall be levied, collected, and paid, for each taxable year *(in addition to the taxes imposed by Title I)*, upon the undistributed adjusted net income of every personal holding company a surtax equal to the sum of the following:

(1) *8* per centum of the amount thereof not in excess of $2,000; plus

(2) *18* per centum of the amount thereof in excess of $2,000 and not in excess of $100,000; plus

(3) *28* per centum of the amount thereof in excess of $100,000 and not in excess of $500,000; plus

(4) *38* per centum of the amount thereof in excess of $500,000 and not in excess of $1,000,000; plus

(5) *48* per centum of the amount thereof in excess of $1,000,000.

(b) DEFINITIONS.—As used in this title—

(1) The term "personal holding company" means any corporations (other than a corporation exempt from taxation under section 101, and other than a bank, *as defined in section 104,* and other than a life-insurance company or surety company) *if*—(A) at least 80 per centum of its gross income for the taxable year is derived from royalties, dividends, interest, annuities, and (except in the case of regular dealers in stock or securities) gains from the sale of stock or securities, and (B) at any time during the last half of the taxable year more than 50 per centum in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals. For the purpose of determining the ownership of stock in a personal holding company—(C) stock owned, directly or indirectly, by a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries; (D) an individual shall be considered as owning, to the exclusion of any other individual, the stock owned, directly or indirectly, by his family, and this rule shall be applied in such manner as to produce the smallest possible number of individuals owning, directly or indirectly, more than 50 per centum in value of the outstanding stock; and (E) the family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

(2) The term "undistributed adjusted net income" means the adjusted net income minus the sum of:

(A) 20 per centum of the excess of the adjusted net income over the amount of dividends received from personal holding companies which are allowable as a *credit* for the purposes of the tax imposed by section 13 or 204;

(B) Amounts used or set aside to retire indebtedness incurred prior to January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness; and

(C) The amount of the dividends paid credit provided in section 27, computed without the benefit of subsection (b) thereof (relating to the dividend carry-over).

(3) The term "adjusted net income" means the net income minus the sum of:

(A) Federal income, war-profits, and excess-profits taxes paid or accrued *during the taxable year to the extent not allowed as a deduction by section 23,* but not including the tax imposed by this section *or a corresponding section of a prior income-tax law;*

(B) Contributions or gifts, not otherwise allowed as a deduction, to or for the use of donees described in section 23(o) for the purposes therein specified, *including, in the case of a corporation organized prior to January 1, 1936, to take over the assets and liabilities of the estate of a decedent, amounts paid in liquidation of any liability of the corporation based on the liability of the decedent to make any such contribution or gift, to the extent such liability of the decedent existed prior to January 1, 1934;* and

(C) Losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117 (d).

(4) The terms used in this section shall have the same meaning as when used in Title I.

(c) ADMINISTRATIVE PROVISIONS.—All provisions of law (including penalties) applicable in respect of the taxes imposed by Title 1 of this Act, shall insofar as not inconsistent with this section, be applicable in respect of the tax imposed by this section, except that the provisions of section 131 of that title shall not be applicable.

(d) PAYMENT OF SURTAX ON PRO RATA SHARES.—The tax imposed by this section shall not apply if *(1)* all the share-

holders of the corporation include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the adjusted net income of the corporation for such year, *and (2) 90 per centum or more of such adjusted net income is so included in the gross income of shareholders other than corporations.* Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his pro rata share, be exempt from tax in the amount of the share so included.

(e) IMPROPER ACCUMULATIONS OF SURPLUS.—For surtax on corporations which accumulate surplus to avoid surtax on stockholders, see section 102.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1940.

No. 8.

CRANE-JOHNSON COMPANY, a Corporation of North Dakota,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE AND BRIEF AMICUS CURIAE.

THOMAS H. REMINGTON,
Rochester, N. Y.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1940.

No. 8.

CRANE-JOHNSON COMPANY, a Corporation of North Dakota,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE.

Comes now the undersigned and moves for leave to file a brief amicus curiae in the above-entitled case on behalf of Bastian Brothers Company. This brief is submitted herewith. The requisite consents having been filed with the Clerk.

THOMAS H. REMINGTON,
Rochester, N. Y.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1940.

No. 8.

CRANE-JOHNSON COMPANY, a Corporation of North Dakota,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

BRIEF AMICUS CURIAE.

May It Please The Court:

If the word "contract" in Section 10 of Article 1 of the Constitution embraces a corporate charter then the unqualified word "contract" also embraces a corporate charter when used in an ordinary statute—no contrary intention appearing.

At the bottom of page 17 and the top of page 18 of the Government's brief we understand this to be conceded. At page 18 of the Government's brief it is also conceded "that laws which exist at the time of the making of a contract and which affect its validity, construction, discharge, or enforcement enter into and form a part of the contract as though they were incorporated in its terms."

From this concession it follows that the provision of the statute of North Dakota which expressly deals with the pay-

ment of dividends and expressly prohibits them is as much a provision of the charter contract as though it were "incorporated in its terms."

Point I.

In the second paragraph on page 18 of its brief the Government makes for its first point that the charter contract was not "executed" by the corporation because "executed" means signed. Obviously this argument cannot be used against a stock certificate. Hence it is out of the *Northwest Steel Rolling Mills* case.

It is stated in Contracts, 17 C. J. Secundum, Sec. 7, p. 326 that the word "executed" often means "made." We submit it means "made" in this statute. Necessarily there are at least two parties to every contract and necessarily both of them make it. Moreover Congress in using this phrase of the law had only in mind the time within which a contract must be made, and that it be in writing. This is obvious from statements in Committee reports quoted on page 23 of Crane-Johnson brief. *There was no reason for attaching any significance to the word "executed."* On the other hand there was every reason for requiring the contract prohibition to antedate May 1, 1936. Otherwise few corporations would have paid any tax. As stated in the Government's brief in the *Northwest Rolling Mills* case the requirement of a written contract was to guard against unscrupulous taxpayers.

Point II.

The second argument of the Government is stated as follows:

> "The most obvious and rational meaning of the words 'a provision of a written contract is a provision expressly written into the contract and not one that is implied.'"

Of course the use of the bald phrase "the most obvious and rational meaning of the words" adds nothing to the

reason of the Government's argument. We deny that this is their obvious and rational meaning. *The statute does not say what the Government asks the court to read it to say.* If Congress had intended to say that, it had facility of expression enough to say it. The lawyers in Congress knew that the State law was a part of the corporate charter and also a part of the stock certificate contract. If they had not desired this principle of law to have full effect they would have phrased the statute differently.

Four rules of construction support the point that the statute should not be construed to require the conceded provision of the contract (Government's brief, page 18) which expressly deals with the payment of dividends to be expressly recopied into the contract. These rules are:

(1) The rule that regards the spirit and purpose of a statute in determining its meaning.

(2) The rule that substance and realities control over form in tax cases.

(3) The rule that doubts in the construction of tax laws must be resolved in favor of taxpayers.

(4) The rule requiring a liberal construction of a relief provision of a tax statute.

Point III.

The third argument of the Government on page 20 is that the prohibition is only on the directors and not on the corporation. A corporation cannot act except through human beings and a prohibition on the only human beings who can do the act for the corporation is necessarily a prohibition on the corporation itself. The Supreme Court of North Dakota has so construed this statute. See page 15, Crane-Johnson Company brief.

The Board of Tax Appeals Misapprehended the Legislative History.

In addition to reasons set forth in the brief for petitioner why the Board of Tax Appeals misapprehended the legislative history, the following is submitted:

The United States Board of Tax Appeals reaches the conclusion that the failure to include a provision in the Revenue Act of 1936 similar to Section 14 of the original house bill was an expression of deliberate intent by Congress not to give relief to deficit corporations. Exception is taken to this conclusion in that it appears from the legislative history that such a conclusion cannot be reached. The intent of Section 14 of the original house bill is best expressed by the following quoted language from Par. XIX in the Report of the Subcommittee of Ways and Means issued under date of March 26, 1936:

> "It is recommended that relief be provided for the corporation which, while having an adjusted net income for the taxable year, lacks sufficient accumulated earnings and profits as of the close of the taxable year from which to distribute *taxable* dividends equal to the adjusted net income." (Italics ours)

The use of the word "taxable" shows this related only to deficit corporations legally able to pay dividends. No others would distribute.

Thereafter in this report examples are quoted, all of which express the hardship which would be suffered by those corporations having accumulated earnings of an amount less than the adjusted net income for one reason or another. Under the existing definition of a dividend as contained in Section 115(a) of the house bill and prior revenue acts, dividends were taxable to shareholders only to the extent that they were paid out of accumulated earnings or profits, so that any corporation actually paying dividends in excess of such earnings and profits would not

receive the dividend paid credit, because the credit provision required a taxable dividend. The recommendation of the Subcommittee on Ways and Means in order to remedy this situation was practically identical with the wording used in Section 14 of the house bill, but the expressed intent of this section was to relieve those corporations which though legally permitted to pay dividends, would not receive the dividend paid credit.

This situation was entirely remedied in the Senate by Section 115(a) of the revenue act of 1936 wherein the definition of a dividend was so changed as to permit a dividend credit for those corporations actually paying dividends if the year's earnings and profits were in excess of such dividends, without regard to the accumulated earnings and profits. Of course this related only to deficit corporations who could legally pay dividends. It was assumed the others would observe the law, and not pay any.

Thus the purpose and intent of Section 14 of the house bill was entirely accomplished in the Senate by the change of the definition of a dividend and it was for this reason that Section 14 of the house bill was not included in the revenue act of 1936.

It is therefore our position that the United States Board of Tax Appeals erred in the case at bar in reaching the conclusion that the failure to include Section 14 of the house bill in the revenue act of 1936, was an expression of deliberate intent not to give relief to any deficit corporations. The only intended relief of Section 14 was that expressed by the Subcommittee of Ways and Means, and this relief was granted by the revenue act of 1936 through the changed definition of a dividend. Section 15 took care of deficit corporations prohibited by charter contract from declaring dividends and it was retained and liberalized.

When the Senate determined to reduce the tax on them to 7 per cent and make relief from it for these corporations conditional upon the distribution of dividends by them it

was necessary to change the definition of a dividend, or such corporations would have had no relief even if they did distribute dividends. This change in the definition of a dividend had nothing to do and did not relate to corporations forbidden by law to distribute dividends. They were taken care of by the contract clause of the statute.

To say that the Senate struck out section 14 to deliberately deny relief to deficit corporations is a speculation which will not square with these facts. The House bill imposed exactly the same flat tax (15 per cent) on undistributed income of deficit corporations which could pay dividends and on undistributed income of corporations forbidden by contract to pay dividends. The Senate bill cut the tax on deficit corporations legally able to pay dividends to 7 per cent and entirely relieved corporations under contract not to pay dividends from the tax. Even deficit corporations legally able to pay dividends were better off under the Senate bill than under the House bill. The Senate bill taxed undistributed income 7 per cent and gave an election to avoid that by distributing income.

Reply to the Reasoning of the Decisions Below.

The proposition for consideration then is: Does the contract involved in this case conform to and comply with the provisions of Section 26 of the Revenue Act of 1936 and so afford appellant the relief it sought in this action? It is our position that it does.

Certainly the title of 26(c)(1) "PROHIBITION ON PAYMENT OF DIVIDENDS" is broad and direct enough to include the credit appellant contends for here. If that be true why should the text of the subsection, having to do with a single provision of a contract, be limited to a point where it works a hardship upon a corporation at a time when it is in no financial condition to be dealt a blow.

The all important "provision" of the contract described in the subsection in question is a provision of a written contract executed by the corporation prior to May 1, 1936,

which provision expressly deals with the payment of dividends.

Now the first point we affirm is, by way of summary for the argument heretofore submitted, that the charter of this taxpayer and the applicable statutes of the State of North Dakota taken together constitute a written contract. The charter is in writing—the statutes are in writing. The entire contract is in writing and complete just as much as if in the drawing of a written contract the draftsman were to provide that certain facts of a certain paragraph "were further exemplified as set out in Exhibit A (a set of specifications) attached hereto and made a part of this contract." The only thing possible of implication is something not expressly set out in the charter or the statutes which is reasonably necessary to the carrying out of the purposes and objectives of the corporation.

Our reason for making the point of what may be implied is because in *Crane-Johnson Co.* v. *Commr. Inter. Rev.*, 105 F. (2d) 740, the court in considering this point said:

> "These statutes, we think, do not establish a contract executed by the corporation expressly dealing with the payment of dividends. *If there is such a contract, it is not an express one, but is implied.*"
>
> "Such contract as arises from the organization of a corporation under state laws is an implied rather than a voluntary written agreement entered into by the corporation."

The mere statement of what the court said against what Section 26 (c)(1) states shows where the court missed the scent of its quarry.

We do not say that "These statutes" establish a contract executed by the corporation expressly dealing with the payment of dividends. What we say is, that the statutes in question constitute "a provision of a written contract * * * which provision expressly deals with the payment of dividends."

It is our further contention that the expression of the court "If there is such a contract it is implied" decides

nothing. Interpreted strictly it says, that if one were to say that "these statutes" were "such a contract" it, the contract, is implied. The statutes are not implied nor can be. They are written and of record. But granted that what the court meant to say was that to make a contract out of the charter and the statutes one had to imply that they were to be taken together, still the court will have said nothing relevant to the point involved in this case because:

The clauses of the section involved here do not provide against the contract in question gaining force by implication. What it does say is that the contract relied upon by the taxpayer shall be a written contract, as this one is, even though it might be said that the two parts are brought together by implication. And then it goes on to say that the "provision" of that written contract shall be one that "expressly deals with the payment of dividends." We submit that the statutes are in writing; that they are one of the provisions of a "written contract" and that they expressly deal with payment of dividends.

Respectfully submitted,

THOMAS H. REMINGTON,
Rochester, N. Y.

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IN THE

Supreme Court of the United States

October Term, 1939.

No. [redacted] 8

CRANE-JOHNSON COMPANY,
Petitioner,

v.

GUY T. HELVERING, Commissioner of Internal Revenue.

MOTION FOR LEAVE TO FILE PETITION FOR REHEARING INSTANTER AND PETITION FOR REHEARING.

JOHN E. HUGHES,
Counsel for Petitioner.

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IN THE

Supreme Court of the United States

October Term, 1939.

No. 584

CRANE-JOHNSON COMPANY,
Petitioner,

v.

GUY T. HELVERING, Commissioner of Internal Revenue.

MOTION FOR LEAVE TO FILE PETITION FOR REHEARING.

Within the time for filing a petition for rehearing herein, this petitioner made a motion for an extension of time to file a rehearing petition until the end of the present term. This Court has not acted on said motion. Petitioner hereby amends said motion to move for leave to file the annexed petition for rehearing instanter. The reason for this motion is contained in the annexed petition.

All of which is respectfully submitted,

JOHN E. HUGHES,
Counsel for Petitioner.

PETITION FOR REHEARING.

Petitioner by its counsel moves that this Court allow this petition for rehearing, vacate the order denying the petition for the writ of *certiorari* and grant *certiorari* to the Circuit Court of Appeals for the Eighth Circuit.

The reason for this motion is that after the denial of *certiorari* herein and on March 1, 1940, the Circuit Court of Appeals for the Ninth Circuit rendered a decision in the case of *Northwest Steel Rolling Mills v. Commissioner* which is squarely in conflict with the decision of the Circuit Court of Appeals for the Eighth Circuit in the case at bar. That opinion expressly refuses to follow the case at bar.

It is published in the C. C. H. and Prentice Hall Tax Services but is not yet published in the Federal Reporter.

On pages 14 and 15 of the response to the petition for the writ a point is made by respondent which he concedes was not the basis of the decision below. The tribunals below decided the merits and would not have done so had respondent's point been well taken.

Respondent stipulated that there was a deficit of $21,251.40 (R. 12). Petitioner's net income was less than this deficit (R. 13, 14). Under the North Dakota statute, quoted on page 19 of the response to the petition, a dividend could only be declared from "surplus profits". As pointed out by the Court below (R. 42) this statute has

been construed by the State Supreme Court. The authority cited in Cook, relied upon at page 15 of the response, consists of English cases decided under a statute which allowed dividends to be paid from current profits irrespective of whether there was a surplus or not. American Statutes require a surplus. On this point see the petition for the writ and supporting brief herein.

There is no merit to this point made by respondent. It was properly ignored by the court below. It is submitted that the decision of a vital issue of national importance in taxation and on which the Circuit Courts of Appeal are in conflict should not be prevented by a meritless quibble which the court below did not deem worthy of notice.

All of which is respectfully submitted,

JOHN E. HUGHES,
Counsel for Petitioner.

SUPREME COURT OF THE UNITED STATES.

No. 8.—October Term, 1940.

Crane-Johnson Company, a Corporation of North Dakota, Petitioner,
vs.
Guy T. Helvering, Commissioner of Internal Revenue.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Eighth Circuit.

[November 12, 1940.]

Mr. Justice Black delivered the opinion of the Court.

Because of a previously existing deficit, petitioner corporation was prohibited by state law[1] from distributing as dividends its profits earned in 1936. Notwithstanding this state prohibition, the Commissioner held respondent liable under the 1936 Revenue Act[2] for surtax on undistributed profits. The Board of Tax Appeals sustained the Commissioner,[3] and the Circuit Court of Appeals affirmed.[4] On a similar state of facts the Court of Appeals for the Ninth Circuit held undistributed profits exempt from surtax.[5] We granted certiorari in both cases to resolve this conflict.[6] The legal questions here presented are in all respects the same as those presented in *Helvering* v. *Northwest Steel Rolling Mills*, this day decided, and on the authority of that case the decision below is

Affirmed.

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1 "The directors of corporations must not make dividends except from the surplus profits arising from the business thereof . . . ." N. D. Comp. Laws (Supp. 1925) section 4543.

2 49 Stat. 1648, 1655.

3 38 B. T. A. 1355.

4 105 F. (2d) 740.

5 Northwest Steel Rolling Mills *v.* Commissioner, 110 F. (2d) 286.

6 309 U. S. 692; 311 U. S. —.